JANUARY 1961

VOL. XXXI NO. 1

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Head of Household,
and Dependents

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Regular Departments

THE NEW YORK Certified Public Accountant

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THE NEW YORK

Certified Public Accountant

January 1961 Volume XXXI No. 1

CONTENTS

DEPARTMENTS

Accounting News And Trends

SURVEY OF MANAGEMENT SERVICES BY CPAS

A report on a management services survey appearing in *The Georgia CPA* (Fall 1960) may be of particular interest to many New York CPAs. It deals with local firms which in the main, ranged from the single practitioner to firms with no more than twenty professional employees. Thus it shows what the smaller firms are doing in this new area of accounting activity.

In the interest of comparability of the individual answers, the committee felt it necessary to provide this definition of management services. "Management Services refers to those services within the competence (or attainable competence) of the average medium sized CPA firm which extend beyond the 'traditional' services of CPAs, such as auditing and tax work." Some of the results of the survey were:

1. Over three-fourths of the firms indicated that demand for management services had recently increased, with the degree of increase generally related to the firm size. More than 20% of all replies indicated demand as having "increased substantially" with a range of from about 10% in the single practitioner class to about 40% in the larger firm class.

2. Replies regarding fees reflected the widest divergence of experience due undoubtedly to the fact that a wide variety of services are embraced by the term "management services" and the fact that fee policies differ broadly between firms.

3. Almost all those surveyed reported that advice regarding insurance records and coverage was the most frequently provided service.

4. After insurance, aid in the field of finance was the most popular, with advice regarding financial policy and planning, and capital structure and requirements, having been given by all but about 15% (mainly single practitioners).

5. Services relative to pension plans, inventory control, and cost accounting had been furnished by about 80%.

6. About one-half had occasionally done arbitration work and about one-third occasionally accumulated and reported trade statistics.

7. Apart from the services related to finance and control, the most popular types of services (dealing with office personnel, equipment, and organization) had been performed by 80% to 90% of the respondents, while the least popular (safety programs, etc.) had been performed by about 5%.

Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is Program Director of the Brooklyn Chapter of the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.

A BANK'S QUERIES ABOUT INVENTORY

A booklet entitled "The Inventory Problem in Accounting," prepared by Professor A. B. Carson for a training program at The Bank of America, contains some questions that a credit

analyst might raise about inventories. These are the questions, and if the answers are not provided in the report, the analyst is advised to present them directly to the accountant:

1. Is the inventory figure based upon a physical count? If not, what is its basis? If based upon perpetual inventory records, how often are these checked by physical count?

2. What is the method of assigning amounts to inventories (i.e., on a FIFO-cost basis, average-cost basis, lower-of-cost-or-market basis, LIFO basis, or other)? If the goods were manufactured, how was factory overhead handled? Is a standard cost system used? If so, are finished goods included at standard cost? How recently were the standards revised? Are the variances from standard sizeable?

3. If LIFO costing was used, what is the approximate current or replacement cost of the inventory?

4. Was the method used in assigning inventory cost consistent with that used in the previous period?

5. Does the method of accounting followed with respect to inventories conform with the usual practice (if any) in the industry?

SPEEDING UP BANK DEPOSIT CREDITS

CPAs whose clients sell goods or services in outlying areas distant from New York can speed up collections by use of a relatively new banking service variously described as "The Lock Box Plan," "Money Mobilization" and similar appellations. In broad outline, this plan is a method whereby customers sent remittances to post office boxes rented in the client's name in cities having Federal Reserve Bank offices or otherwise strategically located in the selling areas. A bank opens the mail, removes and collects the checks, and credits the funds to the client's

account days sooner than if the remittances were sent to the home office.

The advantages which are stated to flow from this plan include: additional working funds; closer control of cash resources; speed and flexibility in movement of money; and simplification of accounting procedures. On the other hand, the cost of the service must be taken into account. Also, companies must determine whether they cannot utilize other expedients, their own personnel, to speed up the transmission of collections to depositories.

CAUTION IN SPECIAL ENGAGEMENTS

In his article "An Ounce of Prevention . . ." (*Mass. CPA Review,* September 1960) Mr. William Holmes outlines the importance to the accountant, client, and interested third parties of defining and understanding the terms of an engagement before it is started. This warning applies especially to special engagements which, depending on their nature, may involve more or less difficulties than the ordinary audit.

An interesting segment of this article is devoted to the problems that arise when an accountant is called in by a client who is considering the purchase of a business. The client naturally wishes to have some verification of the seller's financial statements, and the responsibility of the CPA in this connection is obvious. The author points out that no CPA should start such an engagement until he has had an opportunity to examine the entire contract of sale. Since this may not be immediately available, and since the client is often anxious to get ahead with the purchase, pressure may be exerted on the CPA to get started with "the usual type" audit as quickly as possible. Citing a few unfortunate situations that have developed, the writer suggests that this pressure be

resisted. In one case, when the CPA examined the fine print provisions of the contract, he found that the accountant was to "appraise" the value of certain assets and in another that the accountant was to "Verify" a balance sheet as of a date before the audit. If these responsibilities are unacceptable to the CPA, he may find himself in the unfortunate position of being half though an engagement which he cannot properly complete, or has strong reservations about.

The way to avoid such an embarrassment is clear. The CPA should insist on obtaining the governing contract at the earliest possible moment. Where a staff assistant is assigned to the audit, the partner or manager in charge should nevertheless personally review the contract to appraise the problems posed by the relevant clauses. Of course, if the client could submit a draft of the contract to the CPA before signing it, it is usually not too difficult to have wording clarified to the satisfaction of all parties. Indeed, even if the contract has been signed, it may well be possible, by mutual consent, to vary the wording setting forth the accountant's responsibilities, or to have the lawyers compose a memorandum interpreting problem areas. All of this, of course, should be done before the audit is started or the CPA may regret his willingness to help out a client by a speedy start before his professional responsibilities had been clearly understood.

PRIZE CONTEST FOR TECHNICAL PAPERS

To provide incentives to those who have not previously had papers published in professional journals, the Florida Institute of CPAs is holding a technical paper contest with several prizes of one hundred dollars. The

interesting feature of this contest is its division into scholastic and professional sections. The latter is open to staff members while the former is open to students or recent graduates who wish to enter papers which have previously been submitted as a part of their academic work. This includes term papers and theses.

COMPETITIVE BIDDING INTERPRETATION

In a recent letter to members of the Colorado Society of CPAs the Ethics Committee of that Society states a policy on competitive bidding. Such a practice, it holds, is in violation of the Society by-laws, of the Rules of Professional Conduct promulgated by the State Board of Accountancy, and Rule 14 of the AICPA but questions continue to be asked of the Committee. Here are two noteworthy positions taken by the Society.

The fact that a practitioner is solicited to make an offer to perform a service for a stipulated fee may be presumptive evidence that similar offers are being solicited from other licensed accountants, and it is incumbent upon the member to assure himself to the contrary before making an offer to perform such services.

The rule does not preclude furnishing estimates of probable costs at per diem rates and a maximum fee in instances where the accountant has assured himself that such quotations do not constitute a competitive bid (i.e., he may advise his client who is not seeking a competitive price).

ACCOUNTING FOR NEWSPAPER REVENUE

CPAs who number newspapers among their clients will find much helpful information in the new *Display Advertising Accounting Methods and Procedures Manual* just published by the Institute of Newspaper Controllers

and Finance Officers ($25 from the Institute, P. O. Box 289, Bowling Green Station, New York 4). This 239-page handbook is the result of two years' research and is the third of a series devoted to accounting for newspaper revenue in all its forms; its predecessors dealt, respectively, with circulation and classified advertising.

The handbook is broadly based and contains much material which provide effective management control. It reproduces over 250 forms employed by members in connection with display advertising and incorporates typical manuals covering punched card billing and accounting, and a planning and dispatch department.

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Letters to the Editor

UNRESOLVED ACCOUNTING PROBLEMS IN N. Y. STATE FORM CR-131

Elsewhere in this issue there appears an article, constituting a paper presented by Mr. Bernard Perlman, then Chief, Charities Registration of the N. Y. State Department of Social Welfare, at a technical meeting of our Society's Committee on Accounting for Non-Profit Organizations held on May 25, 1960. Though some progress has been made in clarifying points of contention previously raised by our Committee and others, as to conflicts with prevailing accounting principles inherent in Form CR-131, the annual financial statement filed with the Department by subject organizations, some controversial areas remain unsettled. These issues remain unresolved not because of an unawareness by the Department of their existence, rather, they remain because of a seeming present unreadiness to come to grips with them at this early stage in the existence and administration of the form. Because of widespread interest of accountants in the subject I believe that the unresolved areas should be disclosed, in the hope that it will expedite their resolution.

An examination of the earlier forms will show the considerable improvements that have been effected in making the current Form CR-131 more closely conform to acceptable accounting practices. However, the form still contains some features which are contrary to sound accounting concepts. The authors of the form were concerned that it be simple, concise, and readily understandable to the lay reader to whom it would be made available. Such objectives are commendable, but when they are accomplished without completely following proper (per CPA standards) financial reporting procedures, the results can be misleading. The current form may be satisfactory for a charity which receives only unrestricted contributions. It certainly does not fairly present the operations of a non-profit organization which receives restricted and unrestricted donations, when both are combined in one column.

Article 482-b of the Social Welfare Law requires that the form contain a financial statement which clearly sets forth the "gross income, expenses, and net amount inuring to the benefit of the charitable organization." In order that Form CR-131 more closely conform to the above quoted section of the law, the following changes are suggested:

(1) Provision should be made for those charities that have both restricted and unrestricted funds, to report separately on the operations of such funds. Just as it is legally improper for a trustee or fiduciary to mingle trust funds with his own personal funds, it is equally wrong for a charity to combine restricted funds with its general operating funds. A breakdown of the "balance available from years operations" (the last line of page 1 of Form CR-131) into restricted and unrestricted funds, hardly corrects the distorted picture obtained in the body of the report where they are combined.

The instructions to Form CR-131 require that net gain from the sale of investments be reported as "other" income. Where such investments are part of the restricted funds of a char-

ity it would be wrong to label the net gain on the sale of such investments as "income". A possible way to meet the above objection would be to have two columns on the report, one for unrestricted funds, the other for restricted funds. A third or "total" column is not recommended for reasons already mentioned.

(2) The inclusion of gross receipts from the sale of theater tickets, bazaar merchandise, etc. as "contributions" and the related cost of such tickets and merchandise as "fund raising costs" is difficult to understand. While the relative insignificance of such items might not warrant a separate line on the report, it would be more desirable to include only the excess of proceeds over cost of such items under "contributions." Since the relationship of fund raising expenses to contributions is a key percentage, the inclusion of theater ticket costs and costs of cookies in the numerator can only lead to ridiculous results.

(3) Loans received should not be included under "other income" nor should repayments of loans be part of "other expenditures," even for cash basis organizations. Such receipt or repayment of loans forms no part of "income" or "expenditures" as those terms are understood by accountants. A financial statement which includes such loans received or repaid and yet purports to show the result of financial operations of an organization is obviously misleading.

(4) Depreciation and allowances for bad debts should be made optional. Where income from services rendered forms a major part of the

income of the charity, as in the case of hospital, the practice of charging depreciation and allowances for bad debts to current operations is so prevalent as to constitute an acceptable accounting practice.

(5) The inclusion of a balance sheet and reconciliation of fund balances should also be made optional. A more complete and intelligent picture of a charity can thus be obtained.

(6) The independent public accountant's opinion should be changed. The last sentence reads:

"The information contained on page 1 and or the Schedules on pages 2 and 3 of this report was reviewed on the basis of such examination and, in the opinion of the undersigned, fairly represents the financial operations of this organization in the form required by the department."

The suggested correction is to delete the wording starting with "fairly represents, etc." and substitute the following: "fairly presents the financial data as required in this report."

Until further changes are made in Form CR-131 along the lines suggested in this article, it would seem improper for an accountant to state that such statement "fairly represents the financial operations of the organization, etc."

If the same spirit of earnest cooperation that has existed between the authorities who administer Form CR-131 and our Society continues, it should not be long before the form will comply with those oft used words "in accordance with generally accepted accounting principles."

MAX WASSER, CPA
New York, N. Y.

AVOIDING PENALTIES FOR COMMINGLING FUNDS BY GENERAL INSURANCE AGENTS

Of particular interest to the practicing CPA in New York State, who has insurance agents among his clientele, is the problem of helping his clients comply with the Commingling Law of New York State.

The Commingling Law, on the Statute Books before the turn of the century and revised in 1940 by Section 125 of the Insurance Law of the State of New York, provides that every insurance agent acting as such in the State of New York shall be responsible in a fiduciary capacity for all funds received or collected as insurance agent and shall not, without the express consent of his principal, mingle any such funds with his own funds or with funds held by him in any other capacity.

Regulation 29, promulgated on November 12, 1947 and effective January 1, 1948, resulted from the Insurance Department's consultations with the Industry Committee, and reads as follows:

1. This regulation is issued for the purpose of interpreting and facilitating compliance with Section 125 of the New York Insurance Law.

2. Every insurance agent and insurance broker who does not have the express consent of his or its principals (insurer or insurers) to mingle premium monies with his or its personal funds shall hold such premium monies separate from other funds in accordance with the following rules:

(A) Agents and brokers who do not make immediate remittance to their companies shall not deposit premiums in office operating accounts, but shall keep such monies in a separate bank account from which no disbursements shall be made other than for payment of premiums to companies, return premiums to assureds, for the transfer of commissions or the withdrawal of voluntary deposits.

(B) Voluntary deposits in the premium account in excess of those premiums collected and unpaid to companies may be made for the purpose of maintaining a minimum balance, to guarantee the adequacy of the account, or for the purpose of the payment of premiums to the companies in advance of their collection and when so made may not with withdrawn except to the extent that the remaining balance is at all times equal to the total of net premiums collected and unpaid to insurers.

(C) The deposit of a premium collection in a separate bank account shall not be construed as a mingling by the agent or the broker of the net premium and of the commission portion of the premium; the commission portion of premiums may be withdrawn from the separate bank account at the discretion of the agent or broker.

(D) The maintenance in a separate bank account at all times of at least the net balance of premiums collected and unpaid to the companies by agents operating under the "account current system" shall be construed as compliance with this regulation and with Section 125 of the Insurance Law, provided that the funds so held for each such principal are reasonably ascertainable from the books of account and records of the agents.

(E) Agents and brokers who make immediate remittance of collections to their companies need not maintain separate bank accounts for such collections.

Even though an agent has been granted the privilege, by his companies, to mix company funds with his own, he should not assume that

this gives him permission to pay premiums to companies in behalf of slow paying customers out of funds provided by those customers who pay promptly. There is increasing evidence that the State of New York Insurance Department is taking a dim view of such questionable practices and that it will not be long before company permission to commingle will either not be obtainable or not be honored by the Department. In any event, permission must be obtained from *all* companies, including those where insurance is placed through brokers. Failure to obtain a single such permission nullifies the permits issued by others. Further, a qualified permit will probably be unacceptable to the Department.

The safest way to avoid criticism or penalties from the Insurance Department is for an agent to see to it that (1) he maintains a separate "Insurance Premium" bank account into which he deposits all premiums collected from customers and withdraws therefrom (A) his commission for the month computed at an average rate applied to collections, (B) premium payments to companies and (C) return premiums to customers; (2) his commissions are deposited in an operating account from which his expenses, etc. are drawn and (3) that he makes periodic tests as to the adequacy of the balance in the "agency" account. The latter test may be made in the following manner:

Assume that at the end of December the agent has paid companies through October. He should first age his accounts receivable at December 31 providing three columns, (1) December (2) November and (3) prior months. He should then compute his average commission by reference to his companies' account current. The rate so determined should be used to reduce the total of November and December accounts receivable to a net premium basis. Net amounts due companies for November and December as disclosed by company account currents, or by the agent's ledger accounts, should then be reduced by the net premium equivalent of the accounts receivable for the two months. The result is the minimum amount which should be on deposit in the agency bank account on December 31. A brief tabulation follows to illustrate the computation:

Net premiums, less commissions, due to companies per account currents or agent's company ledger.			
November		$10,000	
December		11,000	
		$21,000	
Accounts receivable, per aging			
November	$ 7,000		
December	9,000		
	$16,000		
Less average commission (20%)	3,200	12,800	
Balance required in "Insurance Premium" account			$8,200

The Certified Public Accountant can be of inestimable aid to those of his clientele who are insurance agents by making periodic tests—at least quarterly—of the adequacy of the "Insurance Premium" cash balance and rendering a report thereon for presentation to insurance department investigators should the client's accounts be subjected to their scrutiny.

Now, what are the chances of your insurance agent client being investigated? Probably no greater than the chance that the tax return of any client may be selected for audit by the Internal Revenue Service. The Albany office of the Insurance Department of the State of New York employs a traveling staff of two men and has under its jurisdiction between 80,000

and 90,000 licensees, so obviously, only superficial coverage is possible.

The procedure followed by the Department's investigator is simple. Using the agent's most recent payments to companies as a guide, he determines the dates of the oldest unpaid items and calls upon the agent to produce his cash receipts record from the earliest of such dates to the day next preceding his examination. For example, if he called on an agent on November 14th, he would probably find that the last payments to companies for other than assigned risks and brokered items were made on or about October 15 and would cover all items written in August. On the other hand, if the investigator waited a day or so he would find that the majority of companies would be paid through September. Except for a few items which he would need to check individually, the investigator would, on November 14, examine cash receipts for the 74 day period September 1 to November 13, inclusive. If his examination were made on November 15, he would reduce his examination period to the 45 day period October 1 through November 14.

The cash receipts record for the required period is checked to customer's accounts and the date of the billing of each item paid is noted on the investigator's schedule. Since he has already ascertained the most recent date of regular billings unpaid to companies, it remains for the investigator to eliminate only assigned risks and brokered policies and then total the items which fall within the previously determined unpaid period.

Deducting from such total an allowance for commissions by applying an average rate, the investigator compares the result with the balance on deposit in the agent's insurance premium bank account. In the event that the amount on deposit is less than the amount computed by the investigator, a penalty for the deficiency will probably be levied by the Department.

Examinations by the Department follow no regular pattern. Whenever the Complaint Bureau sends an investigator to any agency, as a result perhaps of a complaint by an insurer, an assured or a fellow agent, or just a routine test check, that investigator is given orders to check the status of the agency with respect to commingling, regardless of his prime investigative purposes.

While the maximum fine is $500 per offense, the Department has considerable lattitude in fixing fines; generally, the first offense results in a fine of $150 to $200. One word of caution; contrary to a popular notion among agents, there is no such policy of a warning on a first offense. If the

agent is short in his "Insurance Premium" account he will be fined, not warned.

The title preferred by the Department for the agency or trust bank account is "Insurance Premium Account" and it must be on demand deposit in the name of the licensee.

Many agents have attempted to establish a substantial reserve to satisfy their obligations under the commingling law. These reserves, the agents have felt, should earn interest and since commercial banks may not accept interest department deposits from corporations and since savings banks are likewise barred, incorporated agencies have made time deposits with commercial banks. These funds may not be withdrawn without notice, sometimes 90 or 180 days, and it is therefore probable that such deposits would not satisfy the requirement of the commingling law and would not be considered a part of the insurance premium account. A recently announced policy of the Department in this respect is to consider time deposits as part of the insurance premium account in cases where the notice to withdraw required by the depositary does not exceed the payment period allowed by the agency contract with companies (usually 45 to 90 days).

It would appear that, in accordance with this policy, the purchase of shares in New York State Savings and Loan Associations may be considered a part of the insurance premium account since such shares may be surrendered for immediate payment. While these associations reserve the right to a 60-day notice of withdrawal under Chapter 880, Section 380-d of the Banking Law, this is a technical reservation which is seldom, if ever, exercised.

REGINALD H. PATTISON, CPA
Hudson, N. Y.

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Canisius College
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Bernard Rothman (B.B.A.)
Helen Z. Bickman (M.B.A.)

Clarkson College of Technology
Donald Marshall Mills

Columbia University—Institute of Accounting
Leif Rode

Columbia University—Graduate School of Business
Stuart Fleischer

Cornell University—Graduate School of Business and Public Administration
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The award consists of a tie bar bearing the design of the Society's seal appropriately engraved, a scroll, and a one-year subscription to THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT. It is granted annually to the member of the graduating class who has completed the *registered accounting curriculum* with the highest honors in accounting studies.

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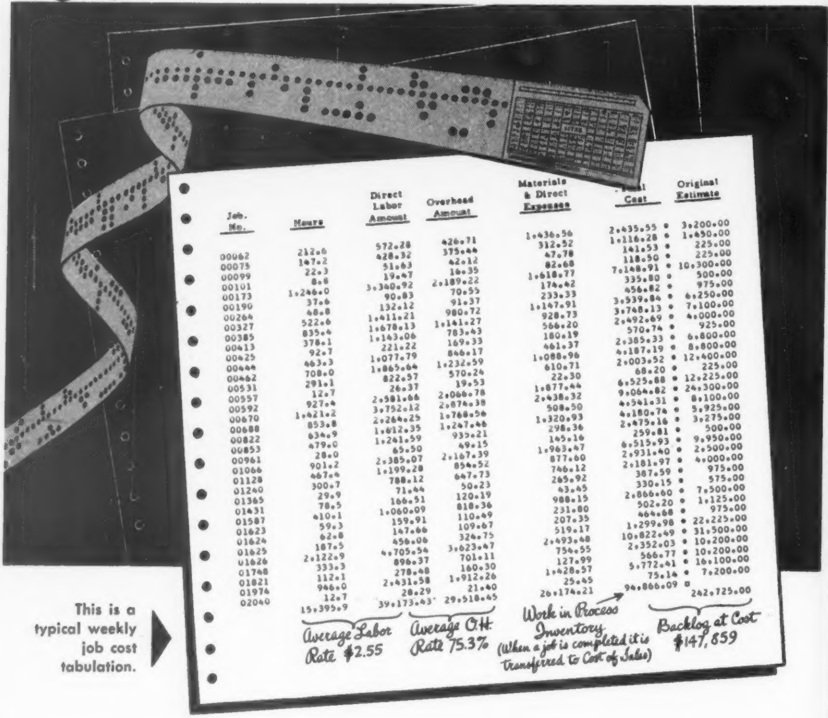

Job. No.	Hours	Direct Labor Amount	Overhead Amount	Materials & Direct Expenses	Total Cost	Original Estimate
00062	212.6	572.28	426.71	1,436.56	2,435.55	3,200.00
00075	147.2	428.32	375.44	312.52	1,116.28	1,450.00
00099	22.3	51.63	42.12	47.78	141.53	225.00
00101	8.8	19.47	16.35	82.68	118.50	225.00
00173	1,246.0	3,340.92	2,189.22	1,618.77	7,148.91	10,300.00
00190	37.6	90.83	70.55	174.42	335.80	500.00
00264	48.8	132.12	91.37	233.33	456.82	975.00
00327	522.6	1,411.21	980.72	1,147.91	3,539.84	6,250.00
00385	835.4	1,678.13	1,141.27	928.73	3,748.13	7,100.00
00413	378.1	1,143.06	783.43	566.20	2,492.69	4,000.00
00425	92.7	221.22	169.33	180.19	570.74	925.00
00444	463.3	1,077.79	846.17	461.37	2,385.33	6,800.00
00462	708.0	1,865.64	1,232.59	1,088.96	4,187.19	8,800.00
00531	291.1	822.57	570.24	610.71	2,003.52	12,400.00
00557	12.7	26.37	19.53	22.30	68.20	225.00
00592	927.4	2,581.66	2,066.78	1,877.44	6,525.88	12,225.00
00670	1,421.2	3,752.12	2,874.38	2,438.32	9,064.82	24,300.00
00688	853.8	2,264.25	1,768.56	508.50	4,541.31	8,100.00
00822	634.9	1,612.35	1,247.46	1,320.93	4,180.74	5,925.00
00853	479.0	1,241.59	935.21	298.36	2,475.16	3,275.00
00961	28.0	65.50	49.15	145.16	259.81	500.00
01066	901.2	2,385.07	2,167.39	1,963.47	6,515.93	9,950.00
01128	467.4	1,199.28	854.52	877.60	2,931.40	2,500.00
01240	300.7	788.12	647.73	746.12	2,181.97	4,000.00
01365	29.9	71.44	50.23	265.92	387.59	975.00
01431	78.5	166.51	120.19	43.45	330.15	575.00
01587	410.1	1,060.09	818.36	988.15	2,866.60	7,500.00
01623	59.3	159.91	110.49	231.80	502.20	1,125.00
01624	62.8	147.66	109.67	207.35	464.68	975.00
01625	187.5	456.06	324.75	519.17	1,299.98	22,225.00
01626	2,122.9	4,705.54	3,623.47	2,493.48	10,822.49	31,500.00
01748	333.3	896.37	701.11	754.55	2,352.03	10,200.00
01821	112.1	278.48	160.30	127.99	566.77	10,200.00
01974	946.0	2,431.58	1,912.26	1,428.57	5,772.41	16,100.00
02040	12.7	28.29	21.40	25.45	75.14	7,200.00
	15,395.9	39,173.43	29,518.45	26,174.21	94,866.09	242,725.00

Average Labor Rate $2.55

Average O.H. Rate 75.3%

Work in Process Inventory (When a job is completed it is transferred to Cost of Sales)

Backlog at Cost $147,859

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THE PRESIDENT'S PAGE

Committee Service

Members of the Society, both in the Metropolitan Area and in the Chapters, should shortly receive invitations to apply for committee service for the coming year beginning June 1.

In common with many others, I have found committee work to be very stimulating, educational and rewarding in many respects. Friendships of long duration have developed. Frequently professional and other beneficial relationships result. Talents, of which we may have been unaware, including the ability to teach, lecture, and write, are uncovered.

Seventy committees in the Metropolitan Area, and 1,100 members are serving the public and themselves through the Society. Corresponding opportunities are offered through fifty Chapter committees. Almost every member, at some time, can be afforded the opportunity to give of himself or herself. Necessarily, it is not always possible to place each applicant on the committee of his or her choice.

The efficient workings of any committee require that some reasonable limit be placed on its numbers. And in the interest of continuity, generally, at least one-third of a committee is reappointed. Likewise, to permit adequate opportunity for others to serve, a policy of rotation is applied to those members who have served on a committee for several years.

Every reasonable effort is made to place members who apply on some committee where their talents can be utilized, even if the committee of their choice is not available. In the comparatively few cases where no

appointment is available, members are specially encouraged to apply in the succeeding year so that appointments can then be made which were previously not possible.

The Committee on Appointments devotes many full days of solid consideration to analyze the requests, suggestions and recommendations of members, to the end that committees be properly staffed. Having served on that Committee, as well as on numerous others, as member and chairman, I have been on both the receiving and delivering end. This may permit me to vouch for the care taken in making committee appointments and the resulting high caliber of members so designated.

The Society is particularly anxious to encourage the active participation of members in commerce and industry in committee service. One of our committees has been energetically emphasizing the mutual benefits of Society membership and activity to CPA members in commerce and industry. A member of that committee, Norbert Muench, was elected to the Society's Board of Directors to fill the vacancy created by the death of F. W. Wulfing. Such members are particularly qualified to serve on numerous committees, including Management Advisory Services, Industry Committees, and many others presenting excellent professional opportunities.

The appointment of committee members, including committee chairmen, affords to a cross section of Society membership the opportunity to advance both the profession's and their own interests. Members young and old, from firms small and large, partners, sole practitioners, staff members, educators, members in commerce, industry and in government service have all served in the past and are all earnestly invited to continue. I strongly urge the interest of our members in this stimulating, educational and rewarding activity.

BENJAMIN GRUND,
President

Accounting and Auditing Problems with Particular Reference to New Registrants with the Securities and Exchange Commission

By ANDREW BARR, CPA

Experience of the past two years at the Securities and Exchange Commission, recent events in accounting circles and some current literature, bolstered by specific suggestions from some of your members, indicate the timeliness of a discussion of certain accounting and auditing problems with particular emphasis on new registrants with the Commission.[1] Some of you may have attended briefing conferences on practice before the SEC at which the programs were largely directed to the legal profession. At these sessions one period has been devoted to accounting with a brief description of the Commission's accounting requirements and some advice for new registrants and their professional advisers, who may have been contemplating their first experience with a registration statement. Discussion of some of the problems which may arise in a new registration statement may be useful here.

ANDREW BARR, CPA, of Illinois, is the Chief Accountant, Securities and Exchange Commission. Mr. Barr taught accounting at Yale University for twelve years and joined the staff of the SEC in 1938 and has served in various capacities with increasing responsibilities since then except for five years in the Army—1941-1946. This article is a paper presented at the November 1, 1960 General Meeting of the Society.

But, first, a few figures may be of interest. For the fiscal year ended June 30, 1950, 496 registration statements were filed under the Securities Act of 1933. During that year the average staff in the Division of Corporation Finance—the division which processes these filings—was 194. During the fiscal years 1958, 1959, and 1960 there were, respectively, 913, 1,226, and 1,628 registrations, and the corresponding average staff of the division was 167, 175, and 181. In ten years we see an increase in this work alone from two and one-half to nine registrations per staff member. Lest this statistic be misinterpreted, it should be observed that the same staff has been faced with an increasing volume in all aspects of its work, which includes proxy material, especially for corporate mergers, applications for listing on exchanges, annual and periodic reports, and in particular time-consuming investigations, stop order

[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

proceedings and assistance to United States attorneys when matters reach a criminal reference stage. This situation has resulted in an increase in the median time from date of filing to effective date from 21 days in 1950 to 24 in 1958, 28 in 1959, and 43 in 1960. In the first quarter of this fiscal year, 393 registration statements were filed, being four less than last year, but the median time from filing date to effective date in this period was 58 days this year compared with 35 days last year. This is the condition our chairman had in mind when he spoke to a workshop conference in Atlanta in August and said that "There have been serious budgetary difficulties within our own agency which have contributed materially to the situation in which we find ourselves and where we simply can no longer promise unreservedly to conform our timetables to the demands of the underwriting industry."

For the benefit of those who have not had any SEC experience I should explain that in processing a registration statement the staff examines the filing and prepares a letter of comment which is sent to the registrant. This letter contains suggestions for amendment of the filing by way of deletions, additional disclosures, correction of text or financial statements, and, in many cases, requests for supplementary information. Although the staff has developed considerable skill in this process, the response to the first letter on a new company may raise new questions to be resolved before the statement may be permitted to become effective. Since a substantial part of the filings in the last two years was made up of new registrants with the Commission, it should be clear that the average processing time I have given was affected materially by these new registrants which required much more time than for companies with prior filings with the Commission.

Included among these new registrations are many filings for the sale of stock by the owners of closed corporations, filings for a combination of such sales and raising of new capital for these corporations, and filings to raise capital for new promotional ventures. Many of these companies are served by local accountants with no previous experience with the SEC, and in many cases counsel for the registrant is also inexperienced in SEC procedure.

These cases have a number of characteristics in common. It seems to the staff that all are filed barely within the ninety-day deadline for the financial statements prescribed by the Act. This means that these statements are at the age limit when filed and of course are growing older during the examination process. Consequently, if the letter of comment is mailed at the end of thirty days and the amendment is filed in twenty days it can readily be seen that the latest financial information will be stale as the financial statements may be six months old by the requested effective date. When such a situation is anticipated the staff usually will alert the registrant to the need for later statements. The alert independent accountant will suggest to his client that preparations be made in advance for immediate response to such a request. This is particularly important if the statements as originally filed include unaudited interim statements to a date near the close of a fiscal year. In this situation preparations for the annual audit should be under way so that the amended registration statement can include certified statements for the full year. This will eliminate the troublesome interim period comparison of income statements in the summary of earnings. It should be noted that the

annual audit must be done anyway if the company will have an obligation to file annual reports under the Securities Exchange Act of 1934. If the audit is completed and year-end statements are included in the registration statement, the filing of a report on Form 10-K would be deferred until the end of the following year. If you know that your client is considering the possibility of a public offering some time in the future, it is important that current year-end audits be planned along generally accepted standards without any limitations on the scope of the independent accountant's work.

Another frequent cause for delay is the tendency on the part of new registrants and their accountants alike to insist that accounting, including tax accounting, which has served adequately for a successful private business is equally good when the company "goes public." This is a mistake. Hours spent on insisting that our staff must accept the statements as presented not only delay the subject filing but take reviewers' valuable time from other cases. Some of the recurring subjects for debate are that all overhead, and sometimes even direct labor, may be omitted from inventory; that cash basis accounting is generally acceptable when inventories of goods for sale are not a factor; that dubious deferred charges must be retained in the balance sheet and amortized over excessively long periods in the future; and that since the company has never prepared consolidated statements before it need not do so now. This last point often brings out the need for recasting financial statements to a common fiscal closing date, particularly in those situations in which a family group of companies is being put together preliminary to the public offering. Another frequent subject for discussion arises when a company which has had an initial public offering under an exemption issues a stock dividend and urges that the minimum amount specified by statutory law rather than accepted accounting practice governs the amount to be recorded for the stock dividend. Many of these subjects are covered in authoritative literature, particularly statements by American Institute committees and rules and decisions of the SEC. I regret to say that frequently much of this sort of discussion is necessary only because the staff of the registrant and its accountants, except for tax law, are not up to date on this and other pertinent literature. It is clear that both parties must effect a change in thinking when the company goes to the public for financing.

This change in attitude must extend also to auditing, and to improvement of accounting and operating procedures necessary for effective internal control which will give confidence to the independent accountant in his work. It is not too surprising that many new companies with phenomenal growth have not kept pace in their accounting work, but it is disturbing to find established companies which have engaged independent accountants for many years in no better position. Because of the unsatisfactory condition of the records, accountants in some cases have had to deny opinions and the staff of the Commission has had to advise that in these circumstances the financial statements did not meet the requirements of the Act for certified statements. These are the extreme cases.

Even for companies with adequate records first audits or first engagements requiring an unqualified certificate are common. In the latter cases the scope of prior audits has been restricted so that observation of inventory taking,

and in some cases confirmation of receivables, is undertaken for the first time in the current engagement. By application of appropriate auditing procedures to the earlier years it is usually possible to render an opinion. This problem was recognized in Accounting Series Release No. 62 relating to opinions on summaries of earnings in a footnote which said:

> "It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances."

Thus it is recognized by the SEC that if the accountant is satisfied by the results of his alternative audit procedures he may certify without a qualification. Mr. Carman G. Blough reached the same conclusion in his column "Current Accounting & Auditing Problems" in THE JOURNAL OF ACCOUNTANCY for May 1953 and in a more extended discussion in March 1956. However, as the latter discussion shows, many accountants feel that reference should be made in their certificate to this situation. This is usually done in an intermediate paragraph referred to in the scope of audit sentence in the first paragraph and usually, but not always, again in the opinion paragraph by way of explanation but not as an exception. If the accountant is not satisfied with the results of his audit procedures he should not certify. Since the circumstances vary widely it is not possible to prescribe a standard certificate to fit all cases. However, the following form of opinion covering the entire life of a company may be a useful example which can be altered to fit:

OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

We have examined the consolidated balance sheet of .... and its wholly-owned subsidiary companies as of April 30, 19...... and the related statement of consolidated income and retained earnings and the summary of earnings for the three years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as indicated in the following paragraph.

We observed the physical inventories as of April 30, 19...... but did not observe the inventories as of April 30, 19...... or 19...... (hereinafter referred to as the "earlier inventories") inasmuch as these dates were prior to our engagement as auditors. We did, however, test-check the pricing and clerical accuracy of those inventories and also made such analytical and statistical tests of related data as we deemed appropriate. As a result of these procedures, nothing came to our attention which would indicate that any significant adjustment should be made to the earlier inventories used in the computation of cost of goods sold for the three years ended April 30, 19.........

In our opinion, the accompanying consolidated balance sheet and the related statement of consolidated income and retained earnings and the summary of earnings present fairly the

consolidated financial position of the companies at April 30, 19........ and the results of their operations for the three years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

....
(Signature)

Before leaving the subject of certificates, there is a problem when the financial statements do not agree with the books. Rule 2-02 of Regulation S-X recognizes this possibility. Paragraph (c) of the rule requires, among other things, that the accountant's certificate shall state clearly "(iii) the nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review." Application of this rule was made in a recent prospectus as follows:

> "The Company has consistently kept its books and filed its Federal income tax returns on the basis of excluding factory overhead from the work-in-process and finished product inventories. The accompanying financial statements have been prepared on the basis of including factory overhead in these inventories (a change in which we concur) and a reserve has been provided for Federal income taxes attributable to this adjustment."

This was followed by the standard opinion paragraph. Further comments on this subject and other matters which arise in our review of financial statements may be found in a paper published in The New York Certified Public Accountant for October 1957.

The foregoing remarks provide a background for a discussion of the competitive problem of the small firm or local practitioner versus the large national firm. Mr. J. S. Seidman, the immediate past president of the American Institute of Certified Public Accountants, used a page in the July-August 1960 CPA to talk to his fellow members on the topic "Minimizing Displacement on Engagements." Four papers presented at the Institute meeting in Philadelphia were devoted to aspects of this problem, presumably at Mr. Seidman's suggestion. Three of these papers are closely related: "Correspondent Engagements—an Untapped Source of Opportunity for CPAs," by E. C. Leonard, Jr.; "Ethics of Correspondent Engagements and Referrals," by John R. Ring; and "The Audit of a Nationwide Company Now Performed by Local Firms"—this is a case study on how to do it presented by A. H. Puder. The fourth paper, by Leslie A. Heath, is entitled "An Ounce of Prevention—Means Dollars to You or Your Estate." This is a warning to single practitioners and very small partnerships. I mention it because we recently had a case in which the financial statements were certified by a single practitioner who died suddenly and left no one to carry on for him. This is a situation which should not arise in any case and particularly in a public company and probably could have been avoided by proper planning.

Displacement of the small local accountant by the large national firm does happen. This may be for at least four reasons, possibly more. Four reasons are: first, the client may realize that the small firm has not been rendering auditing services of the standard required for a certificate and feels that the local accountant is not qualified because of limited staff or

other reasons to do so; second, the local practitioner may not wish to assume the liabilities of a certification in connection with a public offering of securities; third, the underwriters may prefer a national firm, especially when the securities are to be sold outside the area where the local practitioner is known; and fourth, although willing and able to do the work, the local accountant may not be independent under the rules of the Commission.

In the first instance the client would be right if his local accountant tended to limit his practice to bookkeeping and tax service and failed to develop his own capabilities as his client grew. I recall one situation of this kind in which the company entered a period of rapid expansion by opening at new locations. The accountant here conceded that his firm did not have the capacity to render adequate service and felt that he had no means of expanding to cope with the situation. A national firm of accountants took over.

Another example fits my second case. An accountant who confined his practice to bookkeeping service and tax work in his local community had a client which registered with the Commission. A competent job was done on the financial statements, a satisfactory amendment having been filed after a telephone discussion of items in the letter of comment. But in this case I learned that the accountant did not want another registration—life would be easier without expanding his practice in this field. In contrast to this attitude we have observed that some local practitioners do not realize the seriousness of the obligation they are assuming when they undertake to certify financial statements for a registration statement.

The problem of the underwriter is the one of particular concern to Mr. Seidman and which comes to our attention from time to time. In many of these cases the underwriter has no alternative. The filing may be for a newly organized company to take over a group of affiliated companies which have never had an audit on which an opinion could be based. The underwriter's investigation convinces him that only a large firm with adequate staff immediately available can do the work in time and in good form to avoid unnecessary delay. Even in this case the local accountant may perform services in organizing material, developing schedules, and doing other accounting work which will reduce audit time. I know of cases of this kind in which the national firm has certified the statements for registration purposes but the small firm has been retained to continue on cost and tax work and later resumed the audit for annual reporting purposes.

I suppose the most distressing problem for the small firm is to meet the challenge of the underwriter that he is not competent to do the audit required for a certificate for the client he has served for many years while it grew up from a small family enterprise to a leading business in the community. Here the small practitioner with no SEC experience can get advice in many cases from the large firms which render consulting service. The accountant can also get help from the staff of the Commission, and he should not feel that this avenue is closed to him. I have seen instances where I felt that the accountant was reluctant to admit to his client that he was not an expert in SEC work and stayed away from a conference with us for this reason. Telling your client that you know where to get help when you need it and that you can do the job may avoid a displacement. I have seen it done. Experienced firms with large

clients do not hesitate to arrange conferences before filing when new or unusual problems are believed to be present. Clarification in a conference before filing of the accounting principles involved or the manner of compliance with the requirements as to financial statements in a complex or borderline case will save time in meeting a schedule when time is the most important.

The fourth cause of displacement, lack of independence, can be avoided only by looking ahead. Local practitioners as a group seem to feel that the SEC is out of their lives and always will be. In the flood of registration statements of the last two and a half years we have seen many names of accountants we never heard of before and we had never heard of their clients before either. I do not have any more recent statistics than those I used at the Institute meeting in 1957 when I reported that in a list of 3,072 filings on Form 10-K for 1955 and 1956 there were 558 different accounting firms of which 384 each certified to only one statement, 77 firms each certified to two statements, and only the top ten firms each certified to more than 25 statements, as had been the case ten years earlier. While it is undoubtedly true that the big get bigger, there is plenty of evidence that with the growth of small companies into public companies small accounting firms in substantial numbers do follow their clients into the new area of practice. So my suggestion here is to get acqainted with the rules that may affect you before they deprive you of the client you have raised from infancy.

Despite discussion of this topic of independence at every opportunity I have, the frequency of inquiries to my office indicates that repetition will do no harm and may serve to alert some accountants to unsuspected dangers from conflicts of interest. The Commission's rule relating to qualifications of accountants is Rule 2-01 of Regulation S-X. This is the regulation which prescribes the form and content of financial statements for most purposes under the Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940. The forms prescribed under these Acts contain instructions as to what financial statements to file, i. e., what dates and periods, whether parent company, consolidated, group or other combination of statements.

Since we have been receiving a number of inquiries as to who can certify statements for filing with the Commission, I quote paragraph (a) of the rule:

> "(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of his residence or principal office."

To aid us in administering this part of the rule my office attempts to keep a current file of accountants authorized to practice in the several states. Some states publish such lists for all licensed or registered accountants, both certified and not certified. State societies of CPAs cooperate by furnishing copies of directories as they are published. And of course the American Institute's directory is available. If the certifying accountant new to us cannot be identified in this way, we ask for evidence of his qualification

to practice. In a few cases state boards have challenged the accountant's right to certify. Where after review of the facts the accountants were found not to be properly qualified, the registrants were requested to furnish financial statements certified by qualified accountants.

In a recent stop order opinion the Commission noted that one of the accountants involved, who was practicing alone, had used the words "and Company" although this is prohibited under New York law (*Cornucopia Gold Mines*, Securities Act Release No. 6339, August 11, 1960). There is a similar prohibition in the American Institute's Rules of Professional Conduct and in the rules of some of the states, including Ohio. To imply that an individual practitioner has partners is misleading—more so today than a generation ago when it was not quite so hard for a professional man to keep abreast of what is going on in his profession.

Paragraph (b) of Rule 2-01 is:

> "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee."

This is a point the experienced underwriters will check early in the negotiations for the issue of securities. The inexperienced accountant may hear of our rules for the first time from this source. It would, of course, have been better if he had read our regulations and, if he found a possible conflict, consulted with us as to whether anything could be done to cure the situation and avoid embarrassment. In Accounting Series Release No. 81 we listed some cases of possible conflict of interest but upon examination found that the accountants could be deemed independent, sometimes conditioned on certain actions being taken. I suppose it is not necessary to recite in detail the efforts of the American Institute to amend its Rule 13 to bring it more nearly into agreement with the SEC rule. A discussion of the SEC rule may be found in THE JOURNAL OF ACCOUNTANCY for October 1959, so I need not go into further detail here.

Paragraph (c) of Rule 2-01 says:

> "(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

It is under this paragraph that all types of conflicts of interest other than those specifically stated in (b) may be considered in determining whether an accountant is not independent. The most common of these perhaps is the bookkeeping situation which does present problems for the small firm. As Release 81 indicates, we have made exceptions here for emergency services, but our experience shows that continuous bookkeeping service may cause the accountant to become too closely identified, even in his own thinking, with the management. This

is a danger that must be guarded against in the popular demand for expansion of managerial services.

I do not want to leave the impression that it is only the small firm that has problems under our independence rule. Many small firms, in their own practices, have observed rules similar to those of the SEC. Large firms have problems when they obtain new clients or their old clients expand by the merger route or the accounting firms expand by merger. Elimination of conflicting interests must be made.

It should be clear that a familiarity with the Commission's regulations is necessary for all practitioners. We have observed that the small firm is inclined to furnish excessive detail in financial statements and that there is a tendency on the part of larger firms to be over-zealous in the simplification of statements and to be generous in the application of the materiality test. And we encounter from time to time a lack of clarity in notes which skeptics might suspect was intended. The use of prose when tables would make the disclosure crystal clear is a common example.

Exempt offerings of not in excess of $300,000 under Regulation A should not be overlooked in a discussion of this kind. It should be sufficient, however, at this time to say that we do not have two standards of independence, of auditing or of accounting principles. Although the financial statements for this purpose are not required to be certified, if they are certified the accountant must be independent and the audit must be made in accordance with generally accepted standards. In short, the accountant should use the same care as he would for what is usually referred to as a full registration. Generally accepted accounting principles govern in all cases—certified or not certified. Regulation A may be only the first venture into public financing. A good start here will make a full registration easier when it comes.

May I conclude with a few suggestions as to procedure, particularly in complicated cases. First study the requirements of the form on which the registration is to be made. Fit your facts to the instructions as to financial statements. If the result seems to you to be an excessive and confusing collection of statements, try to develop a solution which will produce a better and more useful presentation. Now note that there is an instruction which permits either the registrant or the Commission to propose a substitute for the literal application of the specific instructions. At this point you should apply this rule by working out a solution and then consulting with the staff either by telephone, letter or conference before filing. If the facts change as you approach the filing date, a recheck before printing the financial statements for the registration may be advisable. The result should be a saving in expense for your client and in the long run a saving in time for you and the staff of the Commission.

Annual Report of Charitable Organizations to the New York State Department of Social Welfare—Current Developments

By BERNARD PERLMAN

Form CR-131, required under New York State Law to be filed by welfare organizations with the N. Y. State Department of Social Welfare, raises certain compliance problems for accountants. These problems have been discussed with Department officials by representatives of our Society and others, and some amelioration has already been achieved. This article, by a major official, the Chief, Charities Registration, presents a current interpretation of the requirements of the form for the guidance of accountants. Attention is directed to a Letter to the Editor commenting on accounting problems not resolved by the author.

The New York State program requiring charitable organizations which solicit in New York State to report to the New York State Department of Social Welfare is now five and a half years old and in that period reports have been filed by over six thousand organizations. During this time the Department of Social Welfare has revised its reporting form three times in order to best meet the needs of both the charitable organizations and the independent public accountants whose opinions must be attached thereto by law. Currently the Department of Social Welfare prescribes a form which was revised in November of 1959. This form, CR-131 which is green in color, is utilized for all charitable organizations registered under the law and who intend to or receive contributions in excess of $25,000. in a fiscal year or if they pay someone for performing a fund raising service. In addition to said form, a new short form annual report, form CR-131A, is in the process of adoption and should be out concurrently with the publication of this article. This latter form is to be used by organizations which receive between $10,000. and $25,000. in contributions during a fiscal year and pay no one for performing a fund raising service. However, it is optional with the organization to file the longer form report if they wish. Only the CR-131 requires the opinion of an independent public accountant, the shorter form, CR-131A, merely requires certification by two named officers.

This article will not deal with the problems involved with the short form

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since that has not been in use as yet to any great extent and should not give the accounting profession the problems which it has experienced in the past with the form CR-131.

Those who are not familiar with the article written by Max Wasser which appeared in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT issue of December 1956 entitled "New York State Social Welfare Department Reporting Requirements for Charitable Organizations" should take the opportunity of reading it since it is being used as a base for this paper. That will give you a short history of the first and second report forms used by this Department and the problems which were involved in the adoption of not only the form but the working principles now used by this office.

Form CR-131 currently in use was devised primarily for two purposes, first to provide the lay reader with a short concise standardized picture of the current operations of the organization reporting, and secondly to provide in a logical form a report which can be completed easily by the organizations in accord with the requirements of the program. The uppermost consideration is always to accomplish the first purpose. The form was therefore re-designed to provide on page 1 a combined condensed operating statement for the fiscal year. The items in the statement are to be supported by various schedules on pages 2 and 3 when these schedules are thought necessary. The wording of the independent public accountant's opinion on page 3 had been discussed with The New York State Society of Certified Public Accountants and adopted after such discussion in conformity with the requirements of the law (Section 482B of the Social Welfare Law). Page 4 of the form is merely an informational statement concerning various aspects of the operation of the charitable organization in connection with both its fund raising campaign and any changes made since the time of the last report. In addition there is provided a section entitled "Statement of Services Rendered" for the organization to report in a narrative form, the quantity and nature of the services which it is rendering and which it is requesting the public to support.

There was general agreement that it would be impractical and an almost impossible task to mandate a uniform system of accounts to be maintained by each agency required to report. As the statute was drawn using the Securities Exchange Act as a model, the experience of that agency in securing co-operative action convinced the Legislature that specifying the form and content of the financial statement would eventually accomplish more.

Taking the annual report form (see figures 1, 2, and 3), let us review each Item as listed to indicate the requirements, principle and language used:

A. Contributions—This word is defined in the statute in section 481-2 of the Social Welfare Law as "The promise or grant of any money or property of any kind of value except payments by members of an organization for membership fees, dues, fines or assessments, or for services rendered to individual members, if membership in such organization confers a bona fide right, privilege, professional standing, honor or other direct benefit, other than the right to vote, elect officers, or hold office, and accept money or property received from any governmental authority." From this definition it can readily be seen that any money which is not earned either through a service performed or from the use of money would be construed as a contribution. This item is rather carefully detailed in Schedule No. 1 on

page 2 concerning the location of the area from which the funds are derived, the type of drive, the purpose for which they are solicited, the dates of drives, and to indicate contributions from each drive and the fund raising expenses applicable thereto. In addition to the drive and type of contribution there is also included in the Schedule income from legacies and bequests, Community Chests and affiliated fund raising organizations, grants from foundation, receipts from prior years' pledges and donated merchandise except marketable securities.

Marketable securities are considered as cash and entered in that line on Schedule 1. The entire Item must be reported on a cash basis since we will not accept accruals of contributions receivable but require that it be included when legal title of the asset is transferred. However, allocations received from the Community Chest or United Fund which are not physically in the possession of the organization may be entered if legal title has vested. Contributions, which must be returned in the event a future contingency does not occur, are to be reported when received not when said condition is fulfilled.

Donated merchandise creates a problem of some magnitude. Where such merchandise has readily ascertainable market value there is no difficulty. However in many instances the merchandise does not have a market value which can readily be determined by the accountant. Therefore an estimate based upon past experience or logical comparison must be used. Over-estimation of this item will reduce the related percentage of fund raising costs of the organization so that there is a tendency by certain agencies to raise the value of these assets. If the market value determination can be justified with an acceptable appraisal the Department will have no objection.

B. Investments—Little difficulty is experienced with this item since it is one which is common. What is required is the reporting of bank interest, dividends, bond interest, etc. This can be done on an accrual basis if the books of the organization are so kept. There is no need to provide a supporting schedule as it is felt that detailed information would be of little interest or value.

C. Earnings — Here should be placed on an accrual or cash basis, whichever is pertinent, the income or receipts obtained by providing a service to another party. For example; the sale of a publication, the rental of space, or the receipt of dues in return for which the payor will obtain a vested private profit such as the right to use a swimming pool, a professional honor, etc. It does not include dues income which is primarily given to the organization in order to support the work it is doing. If this is the reason for the person paying his or her dues then in reality he or she is giving a contribution to the organization and the receipt should be reported in that particular Item.

D. Net Income Resulting from Retail Sales of Items in Our Controlled Programs For Handicapped Persons—A special situation is covered for an organization which maintains what is known as a "sheltered workshop". That is, the organization hires handicapped persons to produce various commercial items which it then sells on a retail basis. When this occurs the net proceeds from the retail sales are to be reported here and Schedule 2 must be completed to show not only the income and cost of such operation but also a breakdown by the number of handicapped and non-handicapped production workers and handicapped and non-handicapped sales personnel. This Schedule shows any interested

contributor whether or not the handicapped person for whom the "sheltered workshop" is established is actually benefitting from the operation to the extent that he or she should. It is extremely important that if such schedule is completed the number of persons involved in each operation by category and/or disability be entered.

E. Other—This is the catch-all item for income or other receipts which are not includable in the other four items mentioned above. It would be available for the unusual transactions such as Loans Received for a cash basis organization, Sales of Securities for the same type of organization, Gain or Loss on the Sale of Securities for organizations reporting on an accrual basis, Governmental Subsidies or Special Grants, and any other income or receipt which would not fall within the four previously mentioned categories.

F. Providing the Specific Services for Which We Are Formed—The expenditures and disbursements which the organization incurred in providing the services for which it was formed are to be reported here. A hospital would report not only the cost of maintaining the hospital but also the cost of its research program, a research agency would report the cost of preparing and publishing certain information in addition to its actual research costs. The great difficulty arises when a distinction is to be made between this and Item H which really deals with administrative expenses. If the expenditure is made to further the service which the organization must perform in order to exist and which fosters the purposes set forth in its articles of association or certificate of incorporation then it is entered here. However, if the monies are expended or disbursed to control the organization through record keeping, policy direction, etc., it is to be reported at Item H. While there is no supporting schedule provided for this Item on page 2 and 3 it must be substantiated in the narrative explanation on page 4 under "Statement of Services Rendered". This explanation should at least be consistent with the amount of money spent by the organization and entered in Item F.

G. Grants or Distributions to Member or Recipient Organizations—This creates no problem for it deals with funds which are given or granted to another charitable organization. The details of the gifts are to be shown in Schedule 4. Some misunderstanding has been prevalent concerning distributions to independent chapters, state or national affiliates, all of which should be included on this line in the same manner as other grants and gifts.

H. Managing and Directing The Organization's Affairs (salaries and other expenses)—New terminology is utilized to distinguish what was called "administrative expense." Actually it is not an "administrative expense" it is the managerial expense cost of operating an organization as it encompasses the cost of keeping records, the cost of business management, budgeting, Board activities, etc. Remember that if an organization is established to administer other organizations there must be a distinction made between administering its own affairs and providing a service of administering others.

I. Raising Contributions—This is the cost incurred by the organization in obtaining the contributed income it needs to operate. Not only must direct costs be included but also a portion of all other costs which can be allocated to this function. That would include not only the postage, stationery, and clerical time utilized in a mail campaign but also all costs incurred in planning, make up and approving such

fund raising campaign. Problems do arise when organizations attempt not only to raise funds but also to educate the public at the same time. As money must first be obtained in order to carry out any program we consider the fund raising function paramount.

J. The Purchase of Building and Equipment—This is in reality capital expenses but the terminology was adopted primarily to make it simpler and understandable to a lay person. We will accept any basis upon which an organization handles this item, that is if it writes off small capital expenses as current expenses that is acceptable, similarly if it wishes to capitalize such expenses and enter it into Item J we will also accept that method.

We merely request that if items are capitalized and included here that they be detailed in Schedule 6. The cost of these capital goods are to be reported in the year of purchase. These are not considered to be a transfer of assets from one form to another, for the purchases are to be regarded as expenses and/or expenditures in the year made. The disallowance of depreciation follows the same principle.

K. Other—Another catch-all item this time to cover expenditures which are not includable in the other five listed. Here can be included such items as Refunds, Loss From a Sale of Securities for an accrual organization, Bad Debts written off, etc.

Balance: Finally we obtain a balance available from year's operations. This balance will not reflect charges for depreciation or to a reserve for bad debts. It will be modified cash balance and will include restricted and unrestricted funds. We have done away with a separate schedule for restricted funds for if funds are restricted and the organization wishes to so indicate it can at the bottom of page 1 when it explains the balance left at the end of the year's operations. This has proved perfectly satisfactory to most organizations and provided a much simpler method of showing the restrictions on the income. The explanation of the balance is not a part of the financial statement covered by the independent public accountant's opinion. The reason for this is that we expect to see policy statements here which are not properly within the province of the public accountant's opinion. That is if an organization indicates that it is retaining funds in order to apply it to the next year's operations we cannot expect an accountant to give his opinion as to the proper future use of such retained funds. Also to be noted is the fact that depreciation is not to be reported nor is a reserve for bad debts charge. This is not in accord with some of the published thinking on the subject which has taken the position that either method is acceptable. However the allowance of depreciation as a charge on the current year's operations makes the contributor pay twice for the capital good. Unless there is a monetary sinking fund provided for depreciation the charge is merely one which provides the organization's management with some indicia of the cost of operation. Since most organizations will raise money separately for large capital items and not utilize their current funds, when a depreciation charge is included on the statement it must be a charge on income, which we presume is the contributed income, and so the giver "pays" twice. A reserve for bad debts is again only an estimated expenditure and is one which should not be charged to the contributor of the year in which it is established. Since it is a charge against future income we do not see how the contributor for the year of the report should be required to make up the deficiency. The actual writing off of

bad debts is permitted on the CR-131 since the act is taken in the year involved. Along the same lines is the inclusion of purchase discount as income. Actually this only inflates the income and expenditures of the organization and achieves no salutory result. As many organizations utilize this account on their books, and since it normally involves a very minor amount its placement on the Form CR-131 is not questioned.

Due to the fact that there have not been established acceptable accounting principles for non-profit organizations our task has been tremendously difficult. We have found that charitable organizations take many different views in reporting their activities. What has been attempted is to standardize a report as much as possible without requiring a complete revamping of any bookkeeping system. Frankly there has been endeavored the establishment of a report form which can be judged as a standard. Thus a contributor can compare a report filed here by a hospital with that filed here by a boy scout council. Frankly unless he is a trained accountant and has the time available to do so, I doubt very much if he could obtain any comparison such as this from the printed reports voluntarily furnished by these organizations.

This office and the Department have always worked with The N. Y. State CPA Society in formulating not only the reporting forms but also the language and requirements of the statute. Such relationship in the past has been extremely harmonious and we expect that it will continue to be so. As each new revision of the form is released we have found a more general acceptance by not only the accounting profession but by the charitable organizations themselves. New York State as a result has become a leader in this field for the statutory program administered here is broader than that in any other with the possible exception of the Internal Revenue Service. Our compact centralized operation has been relied upon by contributors not only in New York State but throughout the nation and overseas. The requests received monthly by this office come from as diverse a source as a local Chamber of Commerce in New York State and a Rotary Club in Australia. The figures released annually as to the statistical findings taken from the reports have become a source of valuable information to many persons. The program and its findings have caused an upsurgence of interest in the field and are presently providing a body of study for many groups interested in achieving a degree of uniformity and a standard of high ethics. It has already resulted in a statement of principles by the Los Angeles County Society of Certified Public Accountants and an extremely valuable brochure by Louis Englander entitled "Accounting Principles and Procedures of Philanthropic Institutions". It is hoped that as the desire for uniform accounting principles and practices grows that there will be adopted and utilized many of the practices and standards established by New York State in its current program. It is also hoped that in the future such principles will be evolved through the cooperation of all interested groups; the charitable organizations, the accounting profession, the organizations which report on the value of the soliciting group, and the local, State and Federal governmental agencies which deal with them.

Examinations of Consumer Finance Companies

By THOMAS A. HAEUSSLER, CPA

A great deal of attention is being given to the tremendous expansion in the use of credit by American consumers. As the use of consumer credit has grown, so have the businesses which supply the credit—the personal credit departments of commercial banks, sales finance companies, small loan companies, etc. The demand for independent auditors who are knowledgeable in this industry has increased correspondingly.

Our concern here is with the companies whose business is primarily the making of small loans. These companies operate under the small loan laws of the respective states in which their branches are located. The laws vary somewhat from state to state, but all are rather restrictive in their provisions. The laws set forth, among other things, the maximum interest rates, the maximum amount that may be loaned to one customer, and the types of security permissible. Maximum loan amounts vary from $200 in some states to $5,000 in others. Interest rates are generally on a sliding scale depending upon the size of the loan. For example, in Ohio the maximum interest rate on small loans is three percent per month on the first $150, two percent per month on the next $150 and eight percent per annum on amounts over $300 to $1,000. The loans may be secured by chattel mortgages on household goods, automobiles, farm equipment, trailers, boats, etc., and by wage assignments or they may be unsecured signature loans. The loans may also have the signature of a co-maker on the note.

The small loan companies operate through a number of branch offices. These branches may have more than one corporation operating within the office, and a number of the branches may themselves be separate subsidiary corporations. The larger companies operate through hundreds of branch offices and a correspondingly large number of corporations.

Small loan companies may also have licenses to buy sales finance contracts and to make wholesale or floor plan loans to dealers. Sales finance companies may also have licenses to make small loans. The differentiation generally made between the two types of companies is on the basis of the company's major activity, e.g., small loan companies derive most of their income from small loans and a lesser amount from their sales finance business.

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In the following paragraphs certain accounting and auditing problems peculiar to the typical small loan business are considered in the order in which they are encountered in the financial statements.

Cash: The cash accounts in a small loan company are quite numerous, as they are in any chain operation. There will be at least one fund of cash on hand and one bank account in each branch office. There may be more if more than one corporation is operating in the branches. Also, there will be petty cash funds and operating bank accounts in the home office and inactive bank accounts in which reciprocal balances on bank lines of credit are maintained.

A large amount of audit time can be spent on the examination of these accounts with little justification, since the cash in the branch and home office bank accounts generally is a relatively small part of the company's total assets. The time required to examine the cash accounts can be materially reduced, provided internal check and control is satisfactory, through examining selected accounts on a test basis, and reviewing the company's reconciliations on the others.

Loans receivable: The majority of small loans are made to persons in the lower income groups. These people are generally unfamiliar with business customs; specifically, they are unfamiliar with requests for confirmation from independent auditors. As a result, if positive type confirmation requests are mailed, the response is highly unsatisfactory. The debtors either do not understand the request being made of them or do not care to exert themselves sufficiently to return the confirmation form. It is, therefore, a waste of effort to use positive type requests. The better policy is to send negative type requests to a larger number of debtors.

The confirmation request form should state as clearly and simply as possible the request that is being made. The client's name must be prominently displayed or the customer frequently becomes confused and thinks his account is with the auditing firm. A statement to the effect that the letter is not a request for payment should also be shown prominently.

The investigation of the confirmations returned with differences reported by the customer, those returned by the post office, and of accounts on which the customer has requested that no mail be sent is very difficult for the auditor since the records and customers are, in general, widely spread geographically. The cost of the investigation of these accounts by the independent auditors themselves would be prohibitive. A satisfactory substitute is for the internal audit group to investigate these accounts on their periodic trips to the branches and report the results of their investigations to the independent auditors. The independent auditors can then make such additional examination and confirmation as they deem to be necessary.

Allowance for uncollectible loans: This account is of major importance in a small loan company for two reasons: The comparatively greater credit risk assumed in this type of loan and the fact that loans receivable comprise a very high percentage of the company's assets.

There are two viewpoints concerning these allowances or reserves. . . . One is the traditional accounting viewpoint that such a reserve is a valuation reserve intended to recognize that the loans outstanding at any given date include uncollectible accounts for which a reserve should be established

to reduce the loan balances to an estimated realizable amount. The other viewpoint is that these reserves are not only valuation reserves, but are also reserves against economic declines and, as such, should include an additional provision to take care of losses due to such economic problems. The latter viewpoint is frequently encouraged by the company's creditors who, adopting the traditionally conservative approach, feel more secure with the presence of large reserves for losses on the balance sheet.

The generally accepted practice in the industry is to show the allowance for uncollectible loans as a reduction of receivables whether its amount is determined under the first or the second of the above two theories. If the allowance is determined under the second theory, it would seem that the auditor should decide whether the excess allowances, that is, the amount of the reserve in excess of the amounts justified by experience, is sufficiently material to require presentation as a reserve for contingencies rather than a valuation reserve.

The auditing problem encountered on this account is, of course, the determination of the adequacy of the allowance at the balance sheet date. To do this, the auditor must review the company's method of charging-off uncollectible loans. He will want to know whether the company automatically charges-off loans after a stated period without payments; whether the company keeps the loans on its books until there is absolutely no doubt that they are uncollectible; or whether some intermediate course is followed. A review of the actual charge-offs must be made to see that the stated policy is being followed. The auditor should also review the company's delinquency statistics and compare them to the reserve at the balance sheet date.

One of the most helpful procedures in assisting the auditor in forming his opinion on the allowance for uncollectible loans is a summary showing the relationship of the allowance required at previous balance sheet dates to the receivables at those dates. This can be accomplished through an analysis of each of the past 10 or 15 years' charge-offs by the year in which the loans were made. After determining the total dollar amount of loans made in one year or earlier and charged-off in subsequent years, the amount of reserve required at the end of that year is known. This required reserve can then be stated as a percentage of the loans outstanding at the end of that year. If this is done for each of the past five or ten years, the auditor can see how the percentage at the current balance sheet date compares to the percentage at previous balance sheet dates.

A weighting of the more current years' experience will have to be made, since all of the bad accounts will not yet be charged-off at the current balance sheet date. The last bad accounts may not be charged-off until five, six or seven years after the loan is made. This weighting can be accomplished through an analysis of the early years' experience on the amount of loans charged-off in the first, second, third, fourth and fifth years after the loans were made.

Since the time involved in preparing this computation is quite lengthy, the client should be requested to prepare this summary. The company can also use the summary as substantiation of its deduction for federal income tax purposes.

Unearned discount: This account is of more importance in a sales finance company than in a small loan company. Since small loan companies generally have some sales finance ac-

counts and since some states are permitting a type of small loan with the interest precomputed in the loan balance, the account is discussed here.

Unearned discount arises when a finance company purchases a sales finance contract from an appliance dealer, automobile dealer, etc., or makes a direct loan on a discount basis. The entry recording the unearned discount (disregarding fees, dealers' hold-backs and reserves, etc.) is a charge to loans receivable, a credit to cash, and a credit to unearned discount for the difference between the cash paid-out and the amount to be repaid by the debtor.

Two methods of absorbing unearned discount into income are in use:

1. Recording the proportionate part of the actual payments received that represents discount (cash basis).

2. Recording the discount earned as a result of elapsed time rather than as a result of payments received (accrual basis).

The first method is more frequently used by the larger companies than is the second. In either case tests of these accounts can be made with relative ease by the auditor.

Some companies, generally smaller ones, reverse the above procedure by crediting all discount to earned discount when the paper is purchased and setting-up the unearned portion at each balance sheet date.

Some of the methods used in computing the earned and unearned portions of the finance charges are:

1. Using the "rule of 78" which is a sum of the years' digits approach in which 12/78 of the unearned discount is taken into income the first month, 11/78 the second month, and so on;

2. Computing the percentage that unearned discount is of outstanding sales finance receivables at the first of the month and applying this percentage to the payments received during the month to secure an earned discount figure; and

3. The use of a fixed percentage of outstanding receivables for unearned discount at each balance sheet date.

The last approach is undesirable from an accounting viewpoint since it does not necessarily have any basis in fact and distorts the earned and unearned figures.

Repossessions: This account applies largely to the sales finance business done by the small loan company, and is carried on its books in accordance with one of two methods: at loan balances or at the lower of the loan balance or current market price of the item repossessed. The latter method is preferable.

This account is generally an insignificant one in the balance sheet.

Deferred development costs: Some companies in the consumer finance industry defer the operating losses arising during the first months of operation of a new branch office. These deferred charges are then written-off against income over an arbitrary period such as five years.

This practice has been condemned by some as being contrary to the objective of properly determining net income through the matching of applicable costs and expenses against revenues. These persons advocate that such operating losses should be charged off as incurred in order to conform with generally accepted accounting principles. However, since the practice of deferring initial operating losses of new branch is apparently so widespread in the industry it is considered equally acceptable.

Dealer holdbacks and reserves: In connection with any sales finance activities of the company there will also be dealer holdbacks and reserves

arising from the arrangements made with the dealers for purchasing sales finance contracts from them. Holdbacks and reserves are amounts retained by the finance company at the time the contract is purchased from the dealer and are paid later to the dealer when certain specified conditions or events occur. Holdbacks represent a portion of the financed amount which is held back to cover losses in case of repossession. The reserves are really commissions to the dealer for giving his business to the finance company. The holdbacks are paid to the dealer when the contract is paid-off by the customer. The reserves may be accumulated until they reach an agreed percentage of the dealer's customers' balances depending upon the contract with the dealer. They are adjusted for refunds of finance charges if the customer pays the loan before its maturity date and for bad debt and repossession losses. Periodic payments are made to the dealer of amounts in excess of the agreed-upon percentage.

Where holdbacks and reserves are a significant figure, confirmation of the balances may be secured from the dealers. The transactions in the accounts can be tested with relative ease.

Interest income: Interest income may be recorded either as received from customers or as earned as a result of elapsed time. Generally the larger companies report interest income as payments are received.

Tests of the recorded interest income may be made by selecting various days' payment reports, checking the recorded interest against printed interest tables, and tracing the entries into the records.

Expenses: Some companies consistently report expenses, except income taxes, as paid rather than as accrued. Income taxes are reported on an accrual basis. The auditor must determine whether the distortion resulting from the use of this hybrid method of accounting is material before expressing his opinion on the financial statements. Generally the unrecorded income more than offsets the unrecorded expenses.

Internal control: A system of internal check and control, appropriate to this type of operation, is essential in consumer finance companies where large amounts of cash are readily available and only one or two persons are involved in a complete transaction in the branch office.

The auditor can render a valuable service to his client through recommendations for improvements in the system of internal check and control, and his review of the system as part of his audit procedures will afford him an excellent opportunity to observe areas in which such improvements can be made.

Guide to Joint Returns, Head of Household, and Dependents

By Leonard H. Carter, CPA

JOINT RETURNS

Joint tax returns grant married taxpayers some relief from our high rate structure. Recently, a single woman had sought to use the split income rates for a year in which she had realized substantial income.[1] She appealed her deficiency to a circuit court contending that to withhold the privilege of the split rates from single persons is an arbitrary and unreasonable discrimination that cannot be allowed under the Constitution. It takes no imagination to guess the result because joint returns are still with us.

The concept of joint returns is a creature of the 1948 Revenue Act and was designed to equalize the burden for married people in separate property states with those in community property states.[1a]

All married couples except those legally separated or divorced who satisfy certain conditions may file joint returns.[2] The marital status is determined as of the last day of the taxable year. Consequently, marriage late in a year may be a tax saving device for a high income bachelor. Separated couples living apart without the benefit of a legal separation, and those separated under an interlocutory decree of divorce may still file jointly.[3] A common-law wife, in those states which recognize the relationship, will be considered to be the taxpayer's spouse.[4]

The problem of protecting income splitting pending a final decree of divorce or separation may arise. A wife might be reluctant to sign a joint return during such period. It might be advisable, as part of any preliminary agreement, to provide that the parties will file a joint return prior to the decree of divorce or separation, and at the same time obtain the wife's signature on Form 936 which in effect is a power of attorney.

The same reluctance might exist where estranged couples, not contemplating divorce or separation, are living apart. The spouse with the larger income, as a practical matter, may be compelled to offer some inducement to the other for her participation in a joint return. Here again, Form 936 should be obtained. This will not only insure the filing of a joint return, but will eliminate the necessity of the other spouse seeing the return.

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The further statutory conditions are that (1) neither spouse has been a non-resident alien at any time during the taxable year and (2) both spouses must have the same taxable year. Joint returns are still permitted in the event of the death of one spouse, provided the survivor does not remarry before the end of the year. Each spouse may use different accounting methods, in which event incomes and deductions are aggregated pursuant to the respective separate methods.[5]

JOINT OR SEPARATE RETURNS

The great advantage of filing joint returns is that the income hits tax rates which are lower than those for single persons or married persons filing separate returns.[6] However, the filing of a joint return should not be an automatic act. One disadvantage which should be considered is that the liability for tax is joint and several in the event of joint filing.[7] This problem may be vital where one spouse dies after the filing of a joint return. Any additional taxes may be collected from the separate property of the survivor even though the entire tax related to the income of the decedent. The same problem may exist where there is a divorce or separation after the filing of a joint return.

Mathematical computations should also be made to determine the least expensive way to file. A joint return will always result in less tax where one spouse has no gross income. If both spouses have taxable incomes which are in the same tax brackets, separate returns will usually produce the same combined tax liability as joint returns.

Where both spouses have income, and there are deductions which are limited by income, such as medical and charity, calculations on both bases should be made. It should also be remembered that the capital loss limitation on joint returns is $1,000 whereas on separate returns it is $1,000 for each spouse. Consideration should also be given to the fact that on separate returns each spouse must conform by either itemizing deductions or taking the standard deduction.[8]

Certain dependency deductions may also be lost on a separate return for relatives related by marriage who do not reside in the taxpayer's household. This would apply to aunts, uncles, nieces or nephews of the other spouse, supported by the taxpayer filing separately.

The filing of joint returns may be a useful tool in estate planning work. Where a family partnership of husband and wife exists or there has been assignment of income to the other spouse, the filing of a joint return will eliminate the practical effect of any income tax question as to the validity of income splitting. This has the effect of building the other spouse's estate. Furthermore, the payment of the entire tax by either spouse is not considered a gift to the other of the tax on the other's share of the income.[9]

DEATH OF A SPOUSE

As mentioned before, death of a spouse does not terminate the privilege of filing a joint return for that year. A joint return may be made by the survivor and the executor or administrator of the deceased spouse. Where no representative has been appointed before the filing date the surviving spouse may make the election, but a subsequently appointed executor or administrator may disaffirm the filing of a joint return within one year of its due date.[10]

SURVIVING SPOUSE

A surviving spouse may still have the joint return privilege for a period of two years after the other spouse's death.[11] This is available to those sur-

vivors (1) whose spouse died during either of the two taxable years immediately preceding the taxable year, and (2) who maintains as his home a household which constitutes for the taxable year the principal place of abode of a dependent son or daughter of the taxpayer and for whom the taxpayer is entitled to a dependency deduction for the taxable year.

If the survivor cannot qualify because of the strict dependency requirements, it may be that he or she may meet the tests for "head of household."

A taxpayer is not considered to be a surviving spouse if she has remarried at any time before the close of the taxable year. Remarriage to a nonresident alien would eliminate the survivor benefits, even though no joint return could be filed with the alien spouse. Furthermore, to be a surviving spouse, the survivor must have been able to file a joint return with deceased spouse had he lived. Consequently, income splitting is not allowed if the deceased spouse was a nonresident alien or if there had been a divorce or legal separation prior to death.

CHANGE FROM SEPARATE TO JOINT RETURNS

It is conceivable that where spouses have filed separately, they may have a change of heart and later desire to file an amended joint return. This is permitted provided certain conditions are met.[12] A joint return may be made at any time within the period of limitations even though separate returns had previously been made. The election may not be made if either spouse has instituted proceedings in the Tax Court, or in any court for recovery of part of the tax, or has entered into a closing agreement or a compromise.

The switch to a joint return cannot change any irrevocable election made on the separate returns. Furthermore, the tax liability shown on the joint return must be paid on or before the time for filing. All statutes of limitations are further extended by one year after the joint return is filed.

There is no provision in the Code which will permit the filing of separate returns after a joint return, with one exception. An executor or administrator may disaffirm a joint return already filed by the surviving spouse.

A recent decision has indicated that the prerequisites of changing from separate returns to joint returns must be strictly adhered to.[13] Here, taxpayer had filed a separate return. Upon audit of the return and the assessment of a deficiency, taxpayer had tendered to the agent an offer to make a joint return which agent refused. A deficiency was asserted on the basis of a separate return. The Tax Court held for the government. Taxpayer could have made the election had he filed a return with the district director. Offering such a return to an examining agent is not sufficient compliance with the law.

ESTIMATED TAXES

A word about declarations of estimated tax. Joint declarations may be made under the same circumstances as joint returns.[14] However, such a declaration does not require the filing of a joint final return. The estimated tax may be split between the spouses in any proportions if separate returns are filed. However, if joint declarations are filed, the liability for the estimated tax is also joint and several.

HEAD OF HOUSEHOLD

Limited tax benefits are available to individuals who maintain a household for others. The rates for head of household are midway between the surtax rates of those for joint returns and separate returns.[15]

To qualify, an individual must *not* be married at the close of the taxable year, must *not* be a surviving spouse, and must *not* be a non-resident alien at any time during the year.

Affirmative tests are also necessary for qualification. The taxpayer must maintain a household which is his own home and which constitutes the principal place of abode of other specified individuals, or the taxpayer must maintain a household for his father or mother which need not be his own home.

A taxpayer is not considered as married if at any time during the year his spouse is a non-resident alien. However, a non-resident alien wife, not being a dependent, cannot alone qualify a taxpayer. There must be another individual satisfying the statutory requirements residing in the household.[15a] The taxpayer cannot be a head of household if his spouse died during the year, nor can he be considered to have that status for either of the two years after death if entitled to the benefits of a surviving spouse.

Maintenance of a household for this benefit, and also for the purpose of the benefits of a surviving spouse contemplates the payment of more than one-half of the cost thereof for the taxable year.[16] Such expenses include the payment of rent or home ownership expenses, utility charges and food consumed on the premises. Expenses of maintaining a dependent are not included and would consist of such items as clothing, medical expenses and education.

The persons enabling the taxpayer to fall into this status must be within the following relationships:

(1) A child or grandchild whether or not such individual is a dependent.

(2) Any person for whom a taxpayer can claim a dependency exemption, provided such person is related. Such status may not arise from a multiple support agreement.

(3) A dependent mother or father residing in a separate home maintained by the taxpayer.

It should be noted that those under (1) and (2) above must make their principal place of abode with the taxpayer. A non-dependent parent residing with taxpayer cannot qualify him for head of household status. Furthermore, a married child may only be considered under (1) above if such child is a dependent of the taxpayer.

The household maintained by the taxpayer must be the principal place of abode of the designated individuals and of the taxpayer for the entire taxable year.[17] Temporary absences from such household due to illness, education, vacations, military service will not prevent the taxpayer from qualifying as a "head of household."

It has been held that a bachelor who maintained his sister in a mental institution was a head of household.[18] The facts indicated that his sister had resided with him for many years prior to hospitalization, and that his home was available to her if she could ever return even though it appeared unlikely. The Court ruled that no new place of abode had been established.

On the other hand, the Internal Revenue Service has recently ruled that the maintenance of a mother in a home for elderly women is not the maintenance of a home or household for her.[19] A distinction between the two rulings may hinge upon the intent of permanence of the arrangements.

A District Court has recently allowed a taxpayer a head of household status where his aged mother had moved all her furniture and possessions into his home with the intent of living there. However, prior to the move, his mother had an accident and was hospitalized.

She ultimately died in the hospital. The government contended that there must be a period of initial occupancy before there can be a temporary absence exception. The court held that the intent of the mother to live with her son satisfied the statute.[20]

It is significant that a child may still qualify a taxpayer as a head of household even though that child is the dependent of another.[21] However, the same person cannot be used to qualify more than one taxpayer as the head of a household for the same year.[22]

DEPENDENTS

The foregoing discussion of joint returns and head of household involved the computation of the tax. The subject of dependents involves a deduction to arrive at net income.

A recent decision indicates that the government takes a dim view of taxpayers who claim dependency deductions which may be questionable.[23] In this case the taxpayer, divorced from his wife, claimed dependency deductions for his two sons who resided with his wife. His support of the children was nil. His claim was held fraudulent, and he was sentenced to a prison term even though there was no omission of gross income and the loss of revenue was relatively minor. Although this is an extreme case, it is an indication that care must be taken by taxpayers in considering the rules for deduction discussed herein.

A deduction of $600 is allowed for each dependent.[24] A wife is not a dependent,[25] but a deduction may be taken for a spouse having no income on a separate return of the other spouse, provided the spouse is not the dependent of another taxpayer.[26] This permits a taxpayer to claim a deduction for a non-resident alien wife even though a joint return may not be filed.

A dependent is one, over half of whose support is furnished by the taxpayer, and who falls into one of the following categories:[27]

(1) An individual related to the taxpayer. Residence in the taxpayer's household is not essential to this category.

(2) Any unrelated individual who makes his principal place of abode with the taxpayer for the entire taxable year.

A 1959 amendment assures a deduction for an adopted child for the first year it is taken into the taxpayer's home.[28] Another amendment denies a dependency deduction for a member of a taxpayer's household when the relationship between the claimed dependent and the taxpayer is in violation of local law.[29] This has the effect of denying deductions for common law wives where State laws do not approve of such relationship.

Care should be exercised where husband and wife file separate returns. A spouse cannot claim a deduction for the relative of the other spouse, unless such dependent is a member of the taxpayer's household for the entire taxable year.

The dependent's gross taxable income must be less than $600. This test is waived for a child of the taxpayer under the age of 19, or if over 19 where the child is a student for at least five months of the year at an educational institution.[30] Non-taxable gross income is not considered in determining whether the dependent has received more than $600.

A dependent must be a citizen or resident of the United States or a resident of Canada, Mexico, Panama, the Canal Zone, and in certain cases, the Philippine Islands.[31]

Support Test. The foregoing is a brief summary of the technical rules governing dependency. The broad

areas of conflict on this subject revolve around the support test.

The taxpayer must furnish over one-half of the total support of his claimed dependent during the calendar year. For this determination, comparison must be made of the amount furnished by the taxpayer with the entire amount of the support which the dependent received from all sources, including that provided by his own funds.

Consideration must be given to items received by the dependent such as social security, tax exempt income, pensions and the like. Remember that the foregoing are excluded for the purpose of the $600 gross income test, but must be considered for the support test. If the dependent does not use any of his own funds for his own support, but exists upon the bounty of others, the dependency deduction will not be lost.[32]

It is therefore important to consider what type of payments constitute support for the purpose of determining whether the taxpayer has contributed more than one-half. Of course, the natural items of support include expenditures for food, shelter, clothing, education, medical care and other necessities. However, there are fringe areas where the expenditure may or may not be a necessity depending upon special circumstances or the station in life of the dependent.

For example, in a recent case a controversy developed between a divorced wife and her former husband as to who contributed more to their child's support.[33] The facts were developed that the child was talented and had performed on the radio. Consequently, expenses of dramatic and dancing lessons paid for by the mother were proper support payments. For a non-talented child, they may not be so considered.

The following have been held to be such necessities as to constitute support payments; attendance at a military [34] or parochial school;[35] child care expenses paid to others to enable a mother to work;[36] church contributions;[37] a Lionel train set and its equipment;[38] and recreation and transportation.[39]

The courts have ruled that the following types of payments are not necessities constituting support payments. The cost of capital items such as an automobile,[40] motor boat, rifle or lawn mower;[41] gifts of savings bonds;[42] or income taxes payable by a dependent on his own income.[43]

MULTIPLE SUPPORT AGREEMENTS

Where the support of a dependent is contributed by more than one person, such contributors may annually agree upon the person who shall claim the dependent's deduction.[44] Form 2120, an agreement form, must be submitted with the income tax return of the person claiming the exemption.

Such agreements may be used only where no one person has contributed more than 50% of the support, and where more than half the support is contributed by two or more persons combined, each of whom, but for the support test, could claim the individual as a dependent. Consequently, a multiple support agreement cannot be used where two individuals contributed equally to the support of a dependent.

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Why Is The Property Tax In General Disrepute?

The heyday of the property tax as a prime revenue source has passed, yielding its dubious honor to the income tax, with retail sales taxes close behind. From a high of 73% of all state and local revenues in 1932, property taxes have dropped to 44% currently. Why? Largely because the states have taken over from local governments the expensive functions of highways, welfare, and education, and the states prefer income or excise taxation to property taxation.

Ronald B. Welch of the California State Board of Equalization observes that despite improved administration the property tax still suffers from a poor reputation. Writing for the *Assessors' News-Letter*, Vol. 26, No. 5, he says in "Salvaging the Property Tax" that property has not really been overtaxed but has acquired this reputation from inequities, "especially when imposed at the state level with the traditionally ineffective state equalization" between counties. Mr. Welch would like to improve the popularity of the property tax and believes that it can be done if a greater degree of equity in administration is achieved.

JOURNAL OF TAXATION, November 1960

New York State Tax Forum

Conducted by PETER ELDER, CPA

SOME "PLACE OF BUSINESS" PROBLEMS IN STATE TAX ALLOCATION

The Tax Law and Regulations provide that a taxpayer corporation, upon satisfying certain requirements, may allocate its business income, within and without the State of New York, by multiplying such income by a business allocation percentage. The percentage is determined through the use of three factors: property (real, tangible and rented), business receipts, and payroll. Thus, New York State in using the three factors, has in effect adopted the "Massachusetts" formula, which is also used by many other states. As a general rule, it would appear that the formula is equitable in most situations. However, where the formula works a hardship on a taxpayer, the Tax Commission may be requested to adjust the percentage so as to cause a more equitable result. The following discussion deals with the impact of a "place of business" on the property and business receipts factors, but no reference is made to the payroll factor since it is not pertinent in this limited discussion.

Regular Place of Business—Property Factor

Unless a taxpayer has at least a regular place of business outside of New York during the period covered by the franchise tax report being filed, no allocation of income will be permitted and the allocation will in effect be 100% to New York. The regulations define a regular place of business as any bona fide office, factory, warehouse, or other space which is regularly used by the taxpayer in carrying on its business. If a taxpayer, during the regular course of business, stores property in a public warehouse until it is shipped to customers, the warehouse is considered a regular place of business. Likewise, if during the regular course of business, raw material or partially finished goods of a taxpayer are delivered to an independent contractor for processing, etc., and the finished goods remain with such independent contractor until shipped to customers, the plant of the independent contractor is considered a regular place of business. It should be noted that a statutory office is not included in the definition of "bona fide office."

If a taxpayer satisfies the minimum requirements in connection with a regular place of business outside of New York, so that real or tangible personal property is maintained at such place of business, it will then be entitled to use a percentage of less than 100% for the property factor. This factor is determined by ascertaining the percentage which the average value of the taxpayer's real and tangible personal property (*including* real property rented to it) within the State bears

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to the average value of all the taxpayer's real and tangible personal property (*including* real property rented to it) wherever situated during the period covered by the report.

Permanent Place of Business—Receipts Factor

In order to use a percentage of less than 100% for the receipts factor, it is necessary for the taxpayer to have a permanent or continuous place of business outside New York. In connection with this statement, section 210.3(a)(2)(B) of the Tax Law provides in part, that receipts are allocable to New York from "sales of any property not located at the time of the receipt of or appropriation to the orders at any permanent or continuous place of business maintained by the taxpayer without the state, where the orders were received or accepted within the state - - -." Reg. Art. 413(2) states that "a permanent or continuous place of business maintained by the taxpayer outside New York is any *bona fide* office (other than a statutory office), factory, warehouse, or other space outside New York, *at which the taxpayer is doing business in its own name in a regular and systematic manner,* and which is continuously maintained, occupied and used by the taxpayer in carrying on its business through its regular employees regularly in attendance." (Italics ours.) Thus, we have the interpretation of the statute by the Tax Commission.

The cited regulation not only includes the definition of a regular place of business but also prescribes two further requirements (1) the taxpayer must be doing business in its own name in a regular and systematic manner and (2) it must carry on such business through its regular employees regularly in attendance. It is these additional requirements that quite often present difficulty. Suppose a taxpayer uses a public warehouse outside of New York for the purpose of storing and subsequently distributing its merchandise to customers outside the state and that some of the employees of the warehouse work full time in connection with the taxpayer's business. Does this type of activity satisfy the Tax Commission's interpretation of the statute so as to permit the taxpayer to allocate without New York, receipts from sales arising from merchandise located at the public warehouse?

This was the question the court was asked to decide in *American Chicle Company* v. *State Tax Commission,* 5 A.D. 2d, 318. The facts of the case, in addition to the above question, indicate that the warehouses were occasionally visited by members of the petitioner's regular sales force, and that generally no orders were filled by the warehouse without prior approval of the New York office. The petitioner contended that the public warehouse satisfied the requirements of a permanent or continuous place of business. The court in analyzing the issue indicated that the regulations provide that property stored in a public warehouse is not located at a permanent or continuous place of business, and therefore ruled against the taxpayer. It cited example 6 of the regulations which reads as follows:

> "A taxpayer accepts an order through a salesman or officer working out of its New York office in another state, and fills such order from a stock of goods kept in a public warehouse outside New York. The receipt is allocable to New York."

The court in its decision expressed the view that "there is nothing arbi-

trary or unreasonable about regulations which classify what shall constitute a permanent or continuous place of business." In addition, it was stated "the courts should not interfere with details which administrative agencies employ interpreting a broad statutory place unless the same are arbitrary and unreasonable." The decision, subject to possible appeal by the petitioner, certainly seems to dispel any doubt about the requirements which must be satisfied if a taxpayer wishes to allocate receipts based upon the maintenance of a permanent and continuous place of business outside New York. It is absolutely necessary that such place of business be staffed by its regular employees regularly in attendance in addition to the other requirements.

UNINCORPORATED BUSINESS TAX—NET OPERATING LOSS DEDUCTION

We have received many inquiries in reference to Article 23 as it relates to a deduction of either a net operating loss carryback or carryover. Some of the opinions expressed on the question indicated that a net operating loss deduction would be allowable to a sole proprietor subject to the unincorporated business tax but not to partners subject to such tax; other opinions thought the deduction would be allowable to everyone, while still others thought it would be allowable to no one.

As a result of these differences of opinion, advice was requested from Mr. Robert S. Lewiston, Chief, Regulations and Interpretations Section, Income Tax Bureau, Department of Taxation and Finance in Albany. Mr. Lewiston's reply is shown below:

"Gentlemen:

Your letter dated November 2, 1960 inquires as to the deductibility of net operating loss carryovers for unincorporated business tax purposes under Article 23 of the Tax Law.

A review of this matter indicates that an original draft of Article 23 provided specifically for the deduction of net operating loss carryovers, but such provision was eliminated from the bill at the time of its introduction in the Legislature. This subject was recently reviewed at length by the full Tax Commission and consideration was given to the following:

(a) The net operating loss deduction does not necessarily or completely relate to a business loss but may include non-business losses and must be offset by non-business income items. It is, therefore, an 'omnibus' loss deduction embracing various types of losses and subject to offset by specified categories of income.

(b) Section 703a of the Internal Revenue Code states that the net operating loss deduction shall not be allowed to a partnership.

(c) If the partnership is not allowed a net operating loss deduction when the elements of such deduction would normally be business-connected, it must be inferred that such a deduction would not be allowable for unincorporated business tax purposes to an individual whose net operating loss deduction for normal tax purposes would consist of the statutory grouping of items mentioned in (a) above.

(d) A high level decision had been made prior to the introduction of Article 23 to eliminate the net operating loss deduction from the specific provision of the bill.

The Tax Commission voted at the meeting referred to above not to allow the net operating loss deduction for

unincorporated business tax purposes. This decision is incorporated in the 1960 instructions on Forms IT-202-I and IT-204-I for unincorporated business tax returns and for partnership returns, respectively. I am enclosing a copy of the 1960 Form IT-202-I and invite your attention to the instructions for line 3 of Schedule U-C, which states: 'Note that a net operating loss carryover or carryback may not be deducted for unincorporated business tax purposes.' A similar statement is made in the instructions for line 29 of Schedule U-E of the partnership return. These schedules are for the calculation of the unincorporated business tax on Forms IT-202 and IT-204, respectively."

It is quite clear from the above letter that a net operating loss carryback or carryover will not be allowed when computing income subject to the unincorporated business tax.

TRANSFER AND ESTATE TAX MATTERS

In accordance with the apparent decentralization policy of the Department of Taxation and Finance, a recent announcement indicates that all District Tax Offices of the Department in the New York metropolitan area have been handling transfer and estate tax matters since September 1, 1960.

The District Tax Office at 160-08 Jamaica Avenue, Jamaica 32, New York will process transfer and estate tax proceedings and motions in connection with matters arising from Queens County. Such matters for Nassau and Suffolk Counties will be handled at 140 Old Country Road, Mineola while similar matters for Westchester County will be handled at an office located at 14 Mamaroneck Avenue, White Plains. Prior to this change such matters had been processed by the Brooklyn or New York offices.

Accounting and the SEC

Conducted by Louis H. Rappaport, CPA

SOME QUESTIONS AND ANSWERS ON SEC PRACTICE

The speaker at the Society's general meeting on November 1, 1960 was Andrew Barr, Chief Accountant of the Securities and Exchange Commission. Mr. Barr spoke on the subject of "Accounting and Auditing Problems with Particular Reference to New Registrants with the Securities and Exchange Commission." The overflow meeting was convincing evidence of the interest in what Mr. Barr had to say. For the benefit of those members who were not at the meeting, Mr. Barr's prepared address is reprinted in this issue of *The New York CPA*.

Following the talk, members were invited to ask Mr. Barr any questions that they might have. The period that followed was most stimulating. Many of the questions—and the answers—are also of interest to our members who were not present. Unfortunately, however, there was no stenographic or other record of the question and answer period. The questions that follow were among those that were asked. The answers, on the other hand, are this department's based on our understanding of what practice is in this field.

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Question 1. In connection with a filing under the 1933 Act the auditor has reason to believe that, although the *closing* inventory is correct, there was a serious understatement of *prior* inventories. On the other hand, these book inventories were used in computing *taxable* income. What should the auditor's position be in this situation?

Answer. The auditor has no choice: the financial statements have to be revised so that the inventories and the net income are correctly stated, notwithstanding that this may give rise to a provision for taxes which is greater than the taxes payable as shown by the returns.

Question 2. In first registrations of closely held companies where financial statements had never been published, it is often found that generally accepted accounting principles had not been followed and substantial adjustments on a retroactive basis are required. Assume that the adjustments are made on the books so that the books and financial statements (the first ever to be published by the company) are in agreement. To what extent does the SEC require disclosure (a) in footnotes, (b) in the auditors' certificate?

Answer. The SEC does not require disclosure either in notes to the financial statements or in the auditors' certificate. Rule 3.07 of Regulation S-X (dealing with retroactive adjustment of accounts) was not intended to apply to this situation. The rule is intended to apply to a revision of previously published statements.

Question 3. To what extent will the SEC accept qualified certificates on registrations under the 1933 Act?

Answer. The law and the regulations call for *certified* statements, and there is a real question whether this requirement is met if the accountants' certificate is qualified in important respects. There are some situations in which the SEC will accept qualified certificates. Where, for example, the accountants' opinion is subject to the resolution of an unresolved, clearly disclosed, contingency, the SEC will ordinarily not object to the form of the certificate.

Also, where the accountant did not observe inventories prior to the balance sheet date and has not been able to satisfy himself by other means, the SEC will accept a certificate in which the accountant tells briefly what he has done and says, in effect, that nothing came to his attention which causes him to believe that the earlier inventories and net income are not fairly stated.

In an extreme case the SEC might be forced to accept an accountant's complete disclaimer with respect to the earlier years in a summary of earnings. For example, if the accounting records had been destroyed by fire, the accountant might not be able to find sufficient collateral or supporting evidence to substantiate the representations made in the financial statements. In that case he might have to disclaim an opinion as to the years in question. The SEC might—or might not—accept the certificate, depending on the facts in the particular case. The only safe rule for the accountant to follow in this case is to have a pre-filing conference with the SEC, lay the facts on the table, and arrive at a solution. It is not safe to proceed on the assumption that, since this is all the accountant can say in the case, the SEC must accept it. On the contrary: we have known the SEC to say to a registrant, "You're not ready to file now. Come back in about a year."

Other questions and answers will follow in succeeding issues.

Administration of A CPA Practice

Conducted by HERBERT G. WHITING, CPA

ACCOUNTANTS' WRITING

From time to time we see books, articles and announcements of clinics and seminars which deal with business writing. In general their theme is that business writing is dull and unnatural. As a result reading both letters and reports is time consuming and unduly difficult.

Writing is far more important to professional accountants than to the business community as a whole. In many instances our most important client and prospect contacts are through our letters and reports.

Sometimes a report is the only tangible evidence of work well done. Individuals who have had no prior contact with an accountant may judge his competence and effectiveness entirely by his reports. A well written report should increase opportunities for future service—not only to the client to whom it is addressed but also to attorneys, bankers and others who may be given the report to read for information or recommendations.

Several excellent systems have been devised for measuring the readability of writing. If you will apply them to your letters and reports they will show you how fuzzy and foggy your writing may be. Most accountants are far too busy to apply these systems. The general rule for them to follow is write as if they were talking. If they follow this simple rule the readability of their writing will take care of itself.

Now no one denies that many of the subjects we write about are extremely complex. Long words and sentences are often necessary. Unfortunately, they tend to become a habit, and as they do writing becomes foggier and fuzzier.

The styles used in writing reports should differ widely. Each firm will have its individual preferences and each writer will reflect his own personality. But within this broad framework there are a number of rules which make reports more readable.

One of the best lists of DO's and DONT's we have seen recently appeared in an article in the *Lybrand Journal*. That list, which is taken from an article on reporting to clients on management services engagements, follows:

DO'S

Write sentences in the active, rather than the passive, voice. (The use of the passive allows too great a latitude for sloppy thinking—absence of a subject.)

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Use short sentences; as a matter of style, they are often most effective when interspersed between long sentences.

Keep paragraphs short; long ones tend to lose the reader's interest.

Leave plenty of white space on the page; it adds to reading ease. For example:

(1) Tabulate ideas in separate sentences starting on separate lines.

(2) Use tables rather than knitting numerical information into the text.

(3) Include designs—such as short flow-charts—in the middle of the text.

(4) Provide spaces between captions and paragraphs.

(5) Use double-space or one-and-a-half-space typing, limiting single-space typing to subsidiary text.

Convey expressions in positive—rather than negative—terms.

Underscore words occasionally for particular emphasis. (But this should not be overdone, or the effect of this emphasis will tend to disappear.)

Use "joining words" occasionally to preserve a continuity of style. For example: Therefore—Nevertheless—However.

If there is a risk of cluttering up the text with too much explanatory matter, consider putting it in an appendix.

Avoid capital letters in the text wherever possible. Caption titles, as a rule, should be in lower casing.

Keep adjectival phrases to a minimum; they tend to weaken a sentence.

Use short words in preference to long ones. The reader is more likely to understand them, and the writer is open to less risk of using a wrong word.

If the use of technical words cannot be avoided, explain these terms if there is any doubt of the reader's ability to understand them.

Spell correctly. (The typist cannot be expected to catch every spelling error.)

Be sure that grammatical errors are avoided.

Try to write naturally—as one would speak. (Many people adopt an entirely different style once they start to write. In so doing, they tend to become less effective because they depart from the language normally used to make themselves understood.)

Use dashes — or parenthetical phrases—as occasional methods of relieving a sameness of style.

Occasionally start a sentence with a conjunction. (This may conflict with what one was taught at school. But there are many good examples in the Bible.)

Always read over the draft to make sure that it is clear and understandable —and means only what it is intended to mean.

Finally, when the report is finished, read it critically. Make sure that it represents "completed staff" work.

DONT'S

Don't resort to sarcasm or invective. The report should be written to "help" the client, not to criticize him.

Don't use slang or colloquialisms.

Don't use jargon unless it is regularly used in the client's business and will be properly understood.

Don't use exclamation marks.

Don't use foreign words. English equivalents are easy to find, such as: miles an hour—not miles per hour, that is—not i.e., for example—not e.g., daily—not per diem.

Don't try to impress the client with your learning. Get your ideas across in simple, everyday language.

Don't use the same word excessively. (Refer to a dictionary or to Roget, and select suitable alternatives.)

Don't use long phrases if short ones are equally effective. For example: Not "in the event that . . . ." but, "if . . . ." Not "as a result of this . . . ." but, "therefore."

Don't use periods or colons at the end of captioned headings. They are meaningless.

Don't use the word "etcetera" unless it is absolutely necessary. It is often a hiding place for undigested thought.

Don't use legal phraseology. It is generally too cumbersome.

Don't use technical accounting language unless the report essentially deals with technical accounting matters.

An excellent short work on the subject of clarity in writing is available for thirty-five cents. Its title is *The Language of Audit Reports*. It is published by the Superintendent of Documents, U. S. Government Printing Office, Washington 25, D. C. We know of two accounting firms who have thought so highly of this little publication that they purchased individual copies for each member of their staffs.

FEE SEMINARS

Fees are the lifeblood of any accounting practice. But it is a subject which is rarely discussed openly and frankly among practitioners. When the subject does arise, it often lacks a sense of direction and degenerates into an inconclusive "bull session."

The American Institute's course on Accountants' Fees is designed to overcome these objections. It is a planned program of discussion on all phases of the problem. In general, it deals with the principles and problems of establishing a fair fee structure.

In December our Society's Committee on Administration of Accountant's Practice sponsored two fee seminars. Both were well-attended. In January 1960 over one hundred of our members took time during the busy season for all day meetings on the important subject of fees.

Max Klein reminds us that the Committee is offering the fee seminars on a continuing basis. Seminars will be scheduled as often as groups can be assembled. This is a one day program. Those interested in participating in these extremely interesting and valuable sessions should write to the Committee to indicate when they would like seminars to be scheduled.

JURISPRUDENCE NEEDED IN TAX LAWS

Schemes to avoid the income tax are a product of confusion. And confusion is something we find in all parts of the tax structure which give rise, as in tax avoidance, to new or doubtful cases.

Basically the confusion springs from the fact that the science of law has not been applied to the income tax in the manner in which it has long been employed in older branches of law. Or, as an eminent tax lawyer, the deceased Randolph Paul, once said to me, what we need in income tax law is more jurisprudence.

HERMAN T. REILING, TAXES,
October 1960

Payroll Tax Notes

Conducted by Samuel S. Ress, CPA

REMUNERATION AND WEEKS OF EMPLOYMENT UNDER NEW YORK UNEMPLOYMENT INSURANCE LAW

The Division of Employment of the New York State Department of Labor has issued its most recent series of interpretations and principles for the handling of cases involving "remuneration" and "weeks of employment" under the New York Unemployment Insurance Law.

REMUNERATION

Broadly stated, "remuneration", a term used in benefit rights and experience rating calculations, means every form of compensation paid directly or indirectly to an employee for services rendered. It includes salary, wages, bonuses and reasonable value of board, rent and lodging, and the value of tips or other gratuities received from persons other than the employer. In the last respect it differs from the rule under the Federal Insurance Contributions Act governing the Social Security tax. It also includes compensation paid to principal stockholders provided such compensation is taxable under the Federal Unemployment Tax Act. A "Principal Stockholder" is one who owns 25 percent or more of all the outstanding and issued voting stock of the corporation. Paid vacation or vacation pay, regardless of how it is called is remuneration. Vacation pay to which a dismissed employee is entitled under terms of a contract of employment, is remuneration. Remuneration does not include payments made as dismissal wages which an employer is not under a legal or contractual obligation to pay. Compensation paid to "full-time" day students including payments for work during vacation periods or on holidays, and dismissal wages, while not considered "remuneration" may nevertheless be subject to New York Unemployment Insurance taxation if the employer is subject to the Federal Unemployment Insurance Tax Act and such payments are not in excess of $3000 to the individual recipient during the calendar year.

Remuneration does not include and tax should not be paid on compensation of principal stockholders of corporations not liable for tax under the Federal Unemployment Tax Act. Money paid to an employee as reimbursement for travel expenses or other disbursements of a similar nature are not considered remuneration. Further

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types of payments or forms of compensation excluded from "remuneration" are payments made by an employer, without payroll deduction, of taxes required from his employees under the Social Security Act, or sickness or accident disability payments after six complete calendar months following the month in which the employee last worked. Beginning with the month after the 65th birthday of an employee, any payments, except for vacation or sick pay, for any period for which the employee did not work are also excluded from "remuneration," as are insurance or annuity payments to an employee in retirement. Payments made by an employer to or on behalf of any employee or his dependents under a retirement, sickness, accident, medical, hospital or death benefit plan covering all or a class of his employees, are not considered "remuneration" under the Law.

WEEK OF EMPLOYMENT

A "week of employment" is defined in section 524 of the New York Unemployment Insurance Law. It is a week in which a claimant did some work in employment for an employer liable for contributions. Government employees who are covered for unemployment insurance may also accumulate "weeks of employment" for benefit entitlement purposes. Employees who are "principal stockholders" of corporate employers may not accumulate "weeks of employment" while in the employ of such corporate employers in which they are "principal stockholders" unless the corporate employer is liable for Federal Unemployment Tax contributions.

There are various special circumstances which give rise to problems in applying the law and regulations so as to make more difficult proper determinations in each instance. These are questions that arise in making a determination as to whether or not an employee may be credited with a "week of employment" for both benefit entitlement purposes and for merit rating charges to an employer's individual account with the Unemployment Insurance Fund.

Leave With Pay

1. *Paid vacations and holidays.* Any statutory week which falls within a "vacation period" also represents a "week of employment" which together with the earnings therein, is taken into consideration for determining whether or not the claimant has had the required number of weeks of employment necessary to qualify for benefits under an original claim. The earnings for such paid vacations and holidays are considered in determining a claimant's "average weekly wage" which governs the amount of his weekly benefit.

2. *Other paid leave, such as sick leave.* Regulation 2, section g, issued by the Industrial Commissioner provides that a "week of employment" includes any statutory week during any part of which an employee is on paid vacation or other paid leave of absence even though no actual work is performed.

A leave without pay is not a "week of employment." Payments during disability made under a plan or system and which are not "remuneration" are not available for accumulation of "weeks of employment" credit, if the payments are made by an insurance carrier. They can be credited as "weeks of employment" for the employee if the employer makes direct payments to the employee, either exclusively or in addition to payments made by an insurance carrier. The effect of this interpretation is to remove such payments from taxable wages while preserving them for the

possible use by the employee for unemployment insurance benefit purposes.

Where an employer makes such payments without a plan or system, whether as full or reduced amounts or to supplement sick benefit payments to the employee made by an insurance carrier, such payments to the employee serve as both "weeks of employment" and as "remuneration" to be reported on the employer's quarterly contribution report to the Division of Employment for purposes of taxation.

There is a specific exclusion both as "weeks of employment" and as "remuneration," of payments by an employer on account of sickness or accident disability, or medical or hospitalization expenses in connection with sickness or accident disability. This exclusion becomes effective after the expiration of six calendar months following the last calendar month in which the employee worked for the employer, under section 517, subdivision 2 (d) of the Unemployment Insurance Law.

3. *Retired Workers Payments.* Payments, to fully retired employees, that constitute pensions or other retirement pay do not give rise to "weeks of employment" nor do such payments constitute "remuneration." In cases of superannuated employees who are kept on the payroll without currently performing services, as may occur among some employees in executive positions or in other situations, the employer-employee relationship may not be broken in such an event, particularly if future services in some form are anticipated. These employees are in effect on a paid leave and their earnings create both "weeks of employment" and "remuneration."

There is a break in the employer-employee relationship if no future services are considered. The payments then are in the nature of a pension and are not considered "remuneration" under such circumstances.

It should be remembered that under section 517, subdivision 2 (h) of the Law, which applies to an employee who has reached age 65, that any payment, other than vacation or sick pay, made to such employee, if he did not work for the employer in such period, is excluded from "remuneration" and will not be considered in determining a claimant's entitlement to benefits and his average weekly wage.

Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

WHEN IS A REDEMPTION ESSENTIALLY EQUIVALENT TO A DIVIDEND?

The Eighth Circuit Court of Appeals has affirmed the decision of the Tax Court in the *Heman* case (*Heman et al* v. *Com.* CA-8, 10/25/60 aff'g. 32 TC 479). Although the issues arose under Section 115(g)(1) of the 1939 Code, the provisions of Sections 302 and 301 of the 1954 Code would bring about similar results under the following set of facts.

Two brothers owned all of the preferred and common stock of a corporation except for three qualifying shares. Both brothers also owed substantial sums of money to the corporation which had been withdrawn as loans. One of the brothers died, and his estate consisted principally of his stockholdings. The corporation filed a claim against the estate for the decedent's indebtedness. Under written agreement with the estate, the corporation agreed to accept the decedent's preferred stockholdings in exchange for cancellation of his debt. At the same time a similar agreement was entered into with the surviving brother for a like amount of indebtedness although in the latter case the amount of debt cancelled did not represent the full indebtedness of the surviving brother. The stock was not cancelled but remained in the treasury of the corporation.

Both the Tax Court and the Court of Appeals agreed that the question of whether the redemption was essentially equivalent to a taxable dividend was a question of fact, and both set forth certain criteria to apply in reaching a determination. Because these criteria are of particular interest, they are set forth below:

(1) The presence or absence of a bona fide corporate business purpose; (2) whether the action was initiated by the corporation or by the shareholders; (3) did the corporation continue to operate at a profit; (4) did the corporation adopt any plan or policy of contraction, or did the transaction result in a contraction of the corporation's business; (5) whether the transaction resulted in any substantial change in the proportionate ownership of stock held by the shareholders [now covered by Section 302(b)(2) IRC 1954]; (6) what

were the amounts, frequency and significance of dividends paid in the past; (7) was there a sufficient accumulation of earned surplus to cover the distribution or was it partly from capital.

The Courts found that under the facts in this case, the distribution was equivalent to a taxable dividend, and noted that even if the corporation did benefit from the redemption, "the existence of a single bona fide business purpose" will not suffice, if the net effect of all factors indicates the opposite.

ATTRIBUTION OF STOCK OWNERSHIP

For many years, prior to her death in 1954, Eva L. Beyer, the decedent owned 156 shares out of 283 shares of a corporation. The balance of the shares at the time of her death were held by her daughters and their husbands. During a period of approximately 11 years prior to her death, Mrs. Beyer drew no salary from the corporation of which she was the president. The corporation paid no dividends. However, in each of the years, Mrs. Beyer borrowed sums from the corporation totalling, in the aggregate, about \$20,000, which she used toward living expenses. At her death, her will provided that after settling her estate, her stock was to be distributed equally to her daughters. Prior to the distribution, the estate transferred 51 shares to the corporation in settlement of her debt. This transfer was at the book value of the shares.

The Commissioner asserted, and the Tax Court agreed that this constituted a taxable dividend in the amount of the debt forgiven. Applying the constructive ownership rules of Section 318(a), the stock owned by the husbands was attributed to the daughters, and treated as actually owned by them (Sec. 318(a)(4)). Then, under Sec. 318(a)(2)(A), all of the stock actually and constructively owned by the daughters was attributed to the estate. Thus, both before and after the redemption, the estate owned 100% of the stock.

Since the estate was considered as the sole stockholder, the application of the criteria used in determining whether the distribution was essentially equivalent to a dividend came into play. In view of the history, the absence of dividends, the lack of corporate contraction or any other corporate purpose in redeeming the shares, the Court upheld the Commissioner's determination. (*Thomas G. Lewis et al* 35 TC —— No. 10)

INTEREST DOES NOT HAVE TO BE A BUSINESS EXPENSE OF A CORPORATION

A corporation borrowed money from a loan company (completely owned by the taxpayer's stockholders) and gave mortgages on its property as security. The borrowed funds were loaned to or used for the benefit of the corporation's stockholder. The interest paid on these loans was disallowed as a deduction by the Commissioner on the grounds that it was not an ordinary and necessary business expense of the corporation.

The Tax Court held that the corporate identity in this case was separate from the stockholders, since the taxpayer was formed for a business purpose (and hence was not a sham); that the loans were made to the corporation; that the corporation was the primary obligor and that corporate property was used as security. The Court pointed out that the deduction

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did not have to qualify as an ordinary and necessary expense under Sec. 23(a) IRC 1939 (similar to 162 IRC 1954) since the deduction for interest is specifically provided for in Sec. 23(b) IRC 1939 (similar to Sec. 163 IRC 1954). Accordingly, since the interest was paid on a bona fide loan of the corporation, it was deductible. (*Arcade Realty Co., Inc.* 35 TC —— No. 33)

DETERMINATION OF SELLING PRICE ON INSTALLMENT SALE

In order to report a casual sale of personal property or a sale of real property on the installment basis, the payments in the taxable year of the sale cannot exceed 30% of the sales price.

In the instant case the amount received in the first year in cash and in property was less than 30% of the *stated* sales price. However, a contract which was to be transferred to the seller as part of the purchase price had a fair market value of less than the stated value used in the contract of sale. By taking the contract at fair value instead of stated value, and thus reducing the total selling price, the first year's payments exceed 30%. Accordingly the transaction does not qualify as an installment sale. Furthermore, any gain realized on the contract in excess of its fair market value must be reported as ordinary income. (*William A. Tombari* 35 TC —— No. 32)

DETERMINATION OF PARTNER'S INTEREST IN A CASH BASIS PARTNERSHIP

The following ruling is reproduced in its entirety:

"The taxpayer is a member of a partnership which uses the cash receipts and disbursements method of accounting. At the close of the partnership taxable year, there were outstanding partnership liabilities for the payment of certain trade accounts, notes, and accrued expenses, which liabilities were not recorded on the partnership books because of the method of accounting employed. Held, in computing the adjusted basis of taxpayer's interest in the partnership, for the purpose of determining the extent to which his distributive share of the partnership's loss for such year may be allowed under section 704(d) of the Internal Revenue Code of 1954, the term 'liabilities', as used in section 752 of the Code, includes the partnership's obligations for the payment of outstanding trade accounts, notes, and accrued expenses, whether or not recorded on the partnership books under its accounting method." (Rev. Rul. 60-345, IRB 1960-47, 13.)

WHAT IS THE TEST FOR "TEMPORARY" EMPLOYMENT AWAY FROM HOME?

The Ninth Circuit Court of Appeals has disagreed with the Tax Court that, in determining whether a taxpayer is living "away from home" for the purpose of deducting expenses incurred for travel, meals and lodging, the period of the employment is not "temporary" unless it is predictable.

The Court reasoned that the decision in the case of *Peurifoy* v. *Com.* (S. Ct., 1958, 358 US 59) did not establish a rule "that the place where a taxpayer is employed for an 'indefinite' period is *necessarily* his tax home." Thus, some test is required to determine whether or not the taxpayer's employment is "temporary", since if it is "temporary" the expenses are deductible. However, to hold, as the Tax Court did in this case, that "temporary" means "predictable" is not what Congress intended. Congress wished to eliminate the double burden

of maintaining two homes where an employee was on temporary assignment away from his established residence for an indefinite period of a few weeks or months, since it is unreasonable to expect the employee to dispose of his home on each of such assignments. The Circuit Court of Appeals holds that a preferable test is what the employee knows about the length of time of his assignment. Thus, if he knows that there is a reasonable probability that he will be employed at a new station for a long period of time, he "might be said to change his tax home." What constitutes "a long period of time" varies with the circumstances surrounding each case.

In the instant case the taxpayer, who was in the testing division at Douglas Aircraft Co. plant was assigned to a base 117 miles away. Although he remained there for over a year, the probabilities were that the duration of his assignment would only be several months. Based upon the Circuit Court's test of reasonable expectation, the employment "away from home" was temporary and the expenses deductible. (*John J. Harvey et al* v. *Com.*, CA-9 11/1/60 revg. 32 TC 1368)

COMMENTARY

WORKS OF ART AS BUSINESS FURNISHINGS

Many businesses today are concerned with the "face" they present to the public. In an effort to present the company as something other than an impassive monolith some taxpayers have spent substantial sums of money in decorating their business premises. Many have acquired for use as office or showroom furnishings valuable works of art—paintings, sculpture, mobiles, pottery, etc.

From one point of view, such acquisitions are a good business move. Whether the company's taste runs to classical or modern art, a true work of art can be an excellent investment. However, this very virtue may make prohibitive the after-tax cost of acquiring such assets. Since the value of a work of art may not decline with passing years, it may not be possible to establish a salvage value which is less than acquisition cost. Thus, even if an estimated useful life could be determined, there may be no balance of cost to recover through depreciation deductions.

In ARR 4530, CB II-2, 145 the Service held that art objects were not to be classed as business assets subject to depreciation. The ruling held that since such assets increase in value with age, depreciation claimed by the taxpayer should be disallowed. This is an early ruling and it is interesting to note that it holds that such assets are not "subject to depreciation." One wonders whether under present law the same answer would be given.

The question of whether an asset is subject to depreciation is of importance today for reasons other than an annual deduction. If the work is subject to depreciation (even though the amount may not be ascertainable), it would not be a capital asset and, dependent upon the results of other transactions during the year, the gain or loss upon a sale would be treated as ordinary income or loss, or as capital gain or loss under Sec. 1231. On the

other hand, if the work is not subject to depreciation, then it would be a capital asset and, irrespective of other transactions during the year, gain or loss upon a subsequent sale would be treated only as capital gain or loss.

Taxpayers should not be discouraged if they wish to acquire works of art for business use and at the same time indulge their cultural appetite. However, they should recognize that, unlike other office furnishings, the cost of art may not be recoverable through depreciation but will have to await a sale or other disposition of the art work.

DISTRIBUTIONS OF ESTATE CORPUS

During the period of administration of an estate, there may be over-all tax savings if the estate fails to distribute any income to the beneficiary. This is true when the beneficiary is in high tax brackets, and the estate is in a lower bracket. Those guiding the affairs of such estates should not fall into the trap of making corpus distributions to beneficiaries which could be taxable to them.

Sec. 661 of the Code provides that in computing the taxable income of an estate there shall be allowed as a deduction the sum of (1) any amount of income (as defined under local law) required to be distributed currently and (2) any other amounts properly paid for such taxable year. Sec. 662 is the counterpart of Sec. 661 and provides for the inclusion in the beneficiary's income of the abovementioned items.

Sec. 663(a)(1) excludes from the operation of Sec. 661 and Sec. 662 any amounts paid from principal as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than three installments. Therefore, principal distributions to *residuary* beneficiaries would be taxable to the extent of the undistributed income of the estate for the year.

Regulations Sec. 1.663(a)—1(b) provides that in order to qualify for the exclusion, the distribution must be ascertainable under the terms of the will. For example, a bequest to a decedent's son of an interest in a partnership, is a bequest of specific property. On the other hand, a bequest to a decedent's spouse of money or property, to be selected by the decedent's executor out of the residuary estate, is neither a bequest of a specific sum of money or of specific property for this purpose. This is so despite the fact that for income tax purposes a marital deduction formula bequest may be treated as a bequest of a specific amount and the transfer of property to satisfy the legacy will result in a capital gain or loss to the estate. However, such a bequest is not considered as being a bequest of a specific sum or property under Sec. 663 since the identity of the property, or the amount of money specified, are dependent both on the exercise of the executor's discretion and on the payment of administration expenses or

other charges, neither of which are facts existing on the date of the decedent's death.

Consequently, where it is desirable to have income taxed to an estate, rather than to a beneficiary, care should be taken that corpus distributions will fall within the exceptions of Sec. 663(a)(1).

SPECIAL LOCAL PROPERTY ASSESSMENTS

Special local property assessments for street paving, sewers and other similar benefits, levied by a town or county against the property owners affected, are usually not deductible unless they fall under the provisions of Sec. 164(b)(5). This section permits the taxpayer to deduct local benefit assessments if (a) the assessment is levied by a special taxing district covering at least the whole of one county, and, at least 1,000 persons are subject to the assessment which is levied annually at a uniform rate, or (b) to the extent the taxpayer can prove how much of the tax payment is for maintenance, repair or interest charges. In most cases, therefore, such assessments are not deductible as a tax. (*Caldwell Milling Co.,* 3BTA 1232(1926).)

The Courts have been faced with another aspect of this problem. May such costs be added to the basis of the property affected, for purposes of depreciation, where the property is used in a trade or business, such as an apartment house?

Where the street or sewer improvement was made by the governmental authority itself and the cost assessed against the property owners, the answer seems to be clear that no depreciation deduction is allowable. These extra costs are recoverable only upon disposition of the property.

Where the improvement is put in and paid for by the taxpayer and then the property is conveyed to the municipality for future maintenance, the Courts have similarly held that the taxpayer is not entitled to depreciation. They have further held that the taxpayers will recover their cost only on a disposition of the property (*Algernon Blair, Inc.,* 29 TC 1205 (1958)).

The rationale behind this and other similar decisions is the holding that although the improvements benefited the taxpayer's property, they were not used exclusively in the taxpayer's trade or business but were used primarily for the service of the public. Also, since this was public property the taxpayer did not have that "special pecuniary interest in the property concerning which a depreciation deduction is allowable."

HOW BUYER CAN USE CORPORATION'S CASH TO PURCHASE STOCK

In many situations where a prospective purchaser desires to acquire all the stock of a corporation and he hasn't sufficient cash to effect the purchase, he may wish to use the available cash in the corporation to close the deal. This can be arranged by purchasing less than 100% of the stock, and then having the corporation use its cash to redeem the balance from the selling stockholder. In *Zenz* (213 Fed. (2d) 914; CA-6, 1954) the facts involved a sole stockholder who sold part of her stock to a competitor and had the corporation redeem the balance for cash and property equal to its earned surplus. The court held that the redemption was not a dividend under the terms of Sec. 115(g)(1) of the 1939 Code. The Commissioner acquiesced in that decision and then, in a 1955 revenue ruling, (55-745) stated that the decision would be

equally applicable under the 1954 Code. Evidently Sec. 302(b)(3) can now be relied upon to assure the selling stockholder that payments received from the corporation would be considered as payment for the stock surrendered rather than the equivalent of dividends.

The 1954 Code appears to offer another method of achieving the same result. The corporation, in the alternative, could, by adopting a plan of liquidation pursuant to Sec. 337, sell its assets other than cash without the imposition of a double tax. The tax consequences to the old stockholder would be the same as if there had been a sale and redemption of his stock, while the purchaser would now have two tax advantages he would not have had under the *Zenz* type transaction. Firstly, the basis of the acquired assets would be stepped up to equal the price paid for them. Secondly, the new corporation would commence operations without a carryover of the predecessor's earnings and profits.

CONTRIBUTIONS OF COPYRIGHT INTERESTS

A generous author, desiring to make a gift to a charitable, educational, or religious organization might well be encouraged to consider making it in the form of a copyright interest. *Rev. Rul. 58-260* permits an inventor to make a contribution of an undivided interest in a patent, take a deduction for the fair market value of the interest contributed, and subsequently exclude from his income the royalties earned on the share contributed. This ruling should be equally applicable to undivided interests in copyrights. Furthermore, the Service has also ruled that the right to exploit a copyrighted work in a particular medium is a separate, transferable property. *(Rev. Rul. 54-409.)* If, for example, an author makes a gift of all of his right, title, and interest in the dramatization rights to his novel necessary for its production in a specific medium, such as radio, television, motion pictures or on stage, he is not liable for Federal income tax with respect to any income deriving from his former interest in these rights. *(Rev. Rul. 54-599.)* If the gift is to charity, he would also be entitled to a contribution deduction for the fair market value of the interest donated.

Conceivably, the gift of the copyright (whether of the taxpayer's entire interest, an undivided interest in the whole, or the exploitation rights in a particular medium) could produce an aggregate benefit in tax savings in excess of the amount that the author would have been able to retain out of the royalties. For example, assume that $1,000 in aggregate royalties were forthcoming to an author in the 60% bracket, his retention would be but $400. If he were to make a present gift of the copyright he has a current tax deduction for the present fair market value thereof, say $900, with an immediate benefit of $540, (60% of this $900 value). Furthermore, the cash resulting from the tax saving is available quickly, while the royalty income might be spread out over a period of years.

Substantial tax benefits resulting from charitable contributions are not new, of course, but they can be most dramatically illustrated, as above, in the case of ordinary income assets such as copyrights and inventory.

Classified Section

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